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

In This Issue...

Articles, Research & Spotlights

Arizona Voters Overwhelmingly Approve Public Safety Pension Reform
By Leonard Gilroy, Pete Constant and Anthony Randazzo, Reason Foundation

On May 17th, Arizona voters overwhelmingly approved Proposition 124, the final piece of the Arizona public safety retirement system reform signed into law in February. Proposition 124's passage enacts a constitutional amendment that fully implements the package of reforms that Reason Foundation's Pension Integrity Team played a key role in developing and negotiating as part of a collaborative stakeholder process involving state elected officials, public safety unions and government associations.

With just over 70% approval, Proposition 124 will amend the Arizona state constitution to allow a fix of the broken mechanism currently used by the Public Safety Personnel Retirement System (PSPRS) to provide retirees with protections against inflation so that their purchasing power doesn't erode over time. The constitutional amendment modifies the state's pension protection clause to allow for an exchange of the current, flawed permanent benefit increase (PBI) structure for current workers and retirees for a traditional cost of living adjustment (COLA), based on inflation and capped at 2%. The new COLA design would provide greater certainty to retirees, will be more stable compared to the current PBI system, and will help put the beleaguered pension system on the path to solvency.
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Examining Arizona's Constitutional Amendment to Overhaul Public Safety Pensions

By Alexander "Sasha" Volokh, associate professor of law at Emory Law School

On May 17, 2016, Arizona voters approved Proposition 124, a legislatively referred constitutional amendment affecting post-retirement benefit increases for participants in the Arizona Public Safety Personnel Retirement System (PSPRS). The voter initiative had little opposition—it passed by a 70-30% margin—and consisted of a minor-looking change to Article 29, § 1 of the Arizona Constitution, the so-called "Pension Clause." The purpose of this constitutional change was to ensure the constitutionality of S.B. 1428, a piece of legislation signed into law in February 2016 that made significant changes to PSPRS, which covers state and local law enforcement personnel and firefighters.

But to understand Arizona's Pension Clause and how it stymies pension reform—and why some constitutional change was necessary—we have to go back two years to February 2014 and examine an Arizona Supreme Court case called *Fields v. Elected Officials' Retirement Plan*.
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Exceptional Investment Returns Likely to End

By Truong Bui, Reason Foundation

McKinsey Global Institute recently issued a new report discussing historical and future trends in investment returns. The report finds that the total returns to financial markets in the United States and Western Europe during the past 30 years significantly outperformed the long-term 100-year average.

According to the report, sharp inflation decline, falling interest rates, strong world GDP growth fueled by favorable demographics and productivity gains, and strong corporate profit growth are the key factors that drove the exceptional returns. However, these factors are weakening. Interest rates are likely to rise; an aging world population is expected to dampen GDP growth; and competition from emerging markets coupled with technological disruptions that remove barriers to entry is putting a significant pressure on profit margins.

These fundamental changes are expected to reduce investment returns over the next 20 years. The report estimates that total real returns from US and Western Europe equities over the next 20 years could be 1.5 to 4.0 percentage points below the 1985-2014 average. Similarly, fixed income returns could be 3.0 to 5.0 percentage points lower or more. These estimates have important implications for pension funds, especially public ones that still assume a 7.0-8.0 percent long-term rate of return.
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New GASB Disclosures Allow More Accurate Revaluation of Pension Debt

By Truong Bui, Reason Foundation

Public pension plans have long been relying on flawed discount rates to value their liabilities, and various attempts have been made to estimate the true value of those obligations. A recent paper by pension expert Joshua D. Rauh at the Hoover Institution is among such attempts. What sets this paper apart from previous efforts is its use of the disclosures under the new GASB standards to arrive at more accurate estimates of pension liabilities. The paper is based on an analysis of 564 state and local pension systems, covering 97 percent of the public pension assets in the U.S.

The paper finds that the new GASB guidelines (GASB 67) have no meaningful impact on the way public plans measure their liabilities. Most plans still use their expected returns as discount rates, and in fiscal year 2014 only 11 percent of the plans used discount rates that were on average only 1.1 percent below the expected return. The average discount rate in the sample is 7.41 percent.

The new GASB disclosures however provide interest rate sensitivities, which allow the author to revalue each plan's accrued liabilities with better accuracy. Using the market valuation approach, the author finds that the true aggregate unfunded market value liability is $3.412 trillion, compared to the official $1.191 trillion under GASB 67 standards. The corresponding market value funded ratio is 51.4%, compared to the official 75.2%. The revaluation also reveals that the true annual cost of keeping pension liabilities from rising is 17.5% of state and local budgets, compared to the actual contribution level of 7.3%.
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The Real Costs of Funding Public Pensions

By Truong Bui, Reason Foundation

Public pension advocates often argue that pension costs account for only a small part of state and local spending. According to a recent report by the National Association of State Retirement Administrators, state and local governments spent only 4.1% their budgets on pension contributions in 2013. Andrew Biggs in this article shows why the 4.1 percent figure is misleading.

According to Biggs, public pensions understate their costs by adopting highly lenient funding rules compared to corporate pensions and public pensions in other countries. While public pensions are allowed to discount their liabilities at a high rate reflecting expected returns on assets, corporate plans must use a lower discount rate based on a low-risk corporate bond yield. Corporate plans must also amortize their unfunded liabilities much more quickly than public plans. Biggs finds that if public plans adopted the corporate rules, pension contribution would rise from 24 percent of payroll to 105 percent, and from 4.1 percent of government budgets to 20.4 percent.
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A Pension "Grand Bargain" for Distressed Cities?

By Truong Bui, Reason Foundation

In a recent paper, Howard Husock at the Manhattan Institute explores a novel approach to dealing with municipal financial distress caused by ballooning pension costs. The paper describes the philanthropic coalition that enabled Detroit to emerge from bankruptcy, and examines the possibility of applying this innovative model to four other cities facing similar fiscal problems.

After the largest municipal bankruptcy in history, Detroit was struggling to get back on its feet. The required pension contributions, which amounted to 8 percent of the 2014 budget, crowded out the city's funding for core public services, forcing the city to consider selling many paintings in the city-owned Detroit Institute of Arts to meet its financial needs. Fortunately, a consortium of philanthropic foundations stepped in and pledged $366 million towards a "grand bargain": a combination of philanthropic, corporate, and state donations to pay for the pension debt, in exchange for significant union concessions, including a 4.5 percent reduction in current-retiree pension payments, an end to annual cost of living adjustments, and a freeze on new employee entries into the existing pension plan.

The author sees an opportunity to apply the same grand-bargain model to four other cities: Buffalo, Chicago, Cleveland, and St. Louis. Similar to Detroit, those cities have strong philanthropic communities but are also facing financial problems, characterized by high pension costs, rising property taxes, and high levels of household poverty. The paper finds that a Detroit-style grand bargain would cost less than 2 percent of the assets of those cities' leading foundations.
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Pension Cost Volatility and Public Staffing Levels

By Truong Bui, Reason Foundation

Stephen Eide at the Manhattan Institute in a recent paper discusses the connection between pension cost volatility and public staffing levels. The paper finds that although private-sector job employment has long surpassed its pre-recession levels, state and local government staffing remains lower than it was in 2008.

Rising pension costs are part of the problem. According to the paper, if pension costs had stayed the same as a share of general revenues since 2008, states and localities would have been able to employ about 200,000 more full-time employees. And If pension costs had grown as the same rate as general revenues since 2002, the public staffing levels would have exceeded the pre-recession peak.

Unfunded past service liabilities, not increasing benefits, are the cause of the growing pension costs. In fact, benefits on average are now less generous than they were a decade ago. The current structure of prefunding pension benefits exacerbates the vulnerability of government budgets to market volatility, by raising required contributions to pay for unfunded liabilities at the same time that the tax base shrinks and welfare spending swells. This mechanism reduces the flexibility of managing staffing levels.

Pension reform however could not tame pension cost volatility in the near term, as most reforms concern only future unearned benefits, not past service costs.
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Pension Reform: A Federal Based Proposal

By Truong Bui, Reason Foundation

Pension reform efforts in Illinois and other places have shown that it is almost impossible to reduce earned pension benefits without violating state constitutions. In a recent paper, Diana Furchtgott-Roth at E21 discusses possible solutions to this problem, based on the pension situation in Illinois.

Illinois's pension plans are currently underfunded by $111 billion, with a funded ratio of only 41 percent according to official estimates. A market valuation using a lower discount rate would drop the state's funded status to only 22%, the lowest in the nation. The growing pension obligations have put increasing pressure on the state's budget. Since 1998, taxpayer contributions have risen by 427 percent, compared to the 75 percent increase in employee contributions.

After a constitutional convention in 1970 that granted strong contractual protection to pensions, lawmakers in Illinois no longer had the ability to reduce earned pension benefits. As a result, the Illinois Supreme Court recently struck down a pension reform law signed by former Governor Pat Quinn in 2013.

One solution proposed by the paper, besides a constitutional amendment, is to have Congress create a new section of the US Bankruptcy Code, allowing states to adjust pension benefits after a serious analysis determines that "funding obligations impair the performance of essential state services." This would enable states to override existing state laws and constitutional provisions.
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Quotable Quotes on Pension Reform

"Using an expected cost method back when pensions held mostly bonds was theoretically wrong, but not a problem because both bonds and pension benefits are very, very safe. But using an expected cost method when benefits are guaranteed but investments consist of 70 percent stock and alternatives is just plain wrong."
- Andrew Biggs, resident scholar, American Enterprise Institute

"The current structure of government retirement-benefit systems exacerbates state and city budgets' vulnerability to recessions by requiring more funds to backfill liabilities at the same time that revenues are in shorter supply and demand for many services, such as safety-net programs, is on the rise. Pension costs can crowd out room in budgets even when a recession is not under way. Without a major change in how states and cities fund pensions, continued volatility is guaranteed."
- Stephen Eide, senior fellow, Manhattan Institute

"Everyone agrees that public employees don't have a constitutional right to the continuation of their starting salary; the legislature can reduce public salaries down to minimum wage if they so choose. They don't have a constitutional right to the quality of the working conditions that they experienced on day one; the legislature can steadily make their jobs more and more miserable, within the constraints of federal workplace regulation. They don't have a constitutional right to the continued existence of their own job positions; the legislature can abolish those without notice. They don't even have a constitutional right to continue working in their existing positions; any existing civil service protections can be abolished by the legislature. But God forbid the legislature should make any unfavorable prospective change in public employees' pension calculation formulas: those are vested rights."
- Alexander "Sasha" Volokh, associate professor of law, Emory Law School

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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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