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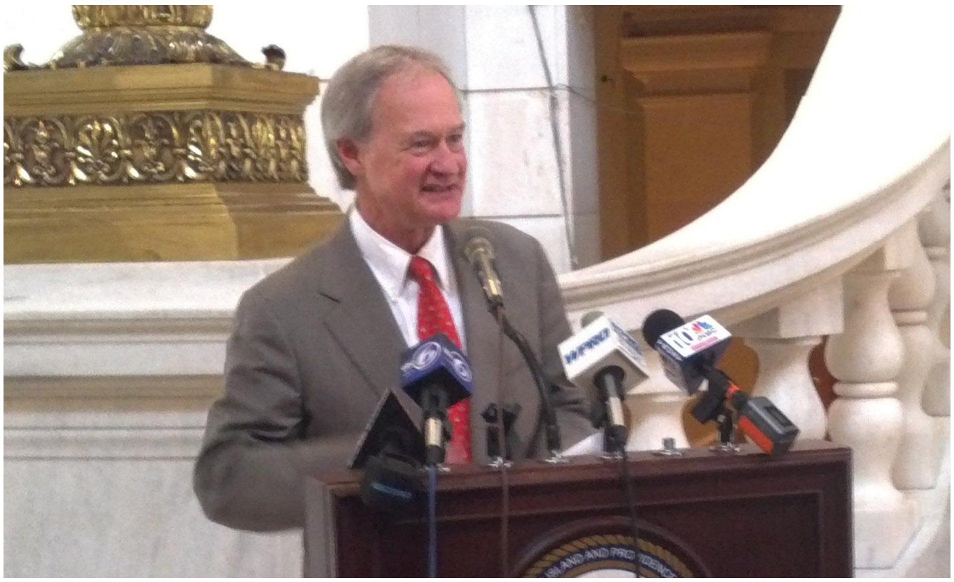
Labor Watch

Best Practices for Reforming State Employee Pensions

New Accounting Standards and Bold State Actions Show Momentum Gaining for Reform

By Ivan Osorio

Summary: *Bloated pensions and retirement benefits for unionized government employees threaten the finances of states and localities across the nation. New accounting standards and bold reforms in some states reveal the "best practices" for governments to use to regain control of their budgets.*



Rhode Island's independent Gov. Lincoln Chafee took on the unions—and won.

Public awareness of America's state pension crisis is growing. Years of overly generous pension commitments to government employees have wreaked havoc on state budgets. During the last four years, state governments across the nation have been trying to bring their labor costs under control, especially pensions, which now impose huge unfunded liabilities. This has been an uphill battle, thanks to fierce opposition to reform from government employee unions.

Underscoring the seriousness of the situation is the recently released report by the State Budget Task Force, a group of experts assembled by former New York Lieutenant Governor Richard Ravitch and former Federal Reserve Chairman Paul Volcker. Launched in April 2011, the bipartisan Task Force includes former Treasury Secretary Nicholas F. Brady, former Secretary of State George P. Shultz, and former Health Education and Welfare Secretary Joseph A. Califano, Jr.

The Task Force released its report, also known as the Ravitch-Volcker report, on July 17 of this year. It analyzes six major threats to states' fiscal sustainability: Medicaid spending; reduced federal aid; lower tax revenue due to eroding tax bases and volatile revenues; local government fiscal stresses; state budget laws that hinder fiscal stability; and underfunded retirement promises. It focuses in detail on six heavily populated states: California, Illinois, New Jersey, New York, Texas, and Virginia.

While underfunded pensions are not the sole cause of states' budget troubles, they are a major one, by the Ravitch-Volcker report's reckoning. Concurring with other estimates (discussed below), it notes that nationwide state and local unfunded pension liabilities are at least $1 trillion, although if those liabilities are calculated using more conservative accounting methods, the true number may be a staggering $3 trillion or more.

The report notes that during the boom times of the 1990s and 2000s, before the financial crisis, state governments spent their growing tax revenues practically as soon as they came into their coffers. "California is an extraordinary example," the report notes.

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State and local governments in the Golden State greatly expanded benefits for their employees and retirees in 1999 and again in 2001. Specifically:

> Senate Bill 400, sponsored and supported strongly by CalPERS [the California Public Employees Retirement System] and signed into law by Governor Gray Davis, increased retirement benefits for state workers by lowering the full retirement age, increasing the benefit formula, or both. It also defined final compensation as the highest 12 months of salary, provided up to a six percent increase in compensation *to those who had already retired*, and increased survivor benefits (emphasis in original).

Californians, to their credit, responded by recalling Davis in 2003, but since then the state has done little to address the underlying causes of its fiscal troubles. Other states have acted more boldly. Despite government unions' opposition, lawmakers in most states have been able to enact some reforms, of varying boldness. As a March 2012 study from the National Conference of State Legislatures reports: "From 2009 through 2011, 43 states enacted major changes in state retirement plans for broad categories of public employees and teachers to address long-term funding issues."

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Reforms included:

- Increased employee contributions
- Higher age and service requirements for retirement
- Reduced commitments to post-retirement cost of living benefit increases
- Changes in formulas for calculating benefits.

Such measures are a good start, but for pension reform to be long-lasting, lawmakers must take on some deeply entrenched structural factors that drive pension problems.

Structural Factors

"Best practices" for state reforms require that legislators deal with the following issues.

1. Pension payouts based on final-year pay. Many pension funds set retiree payouts based on the retiree's final-year earnings, rather than a career average. This has enabled some public employees to engage in a practice known as "spiking," in which employees rack up overtime during their last year on the job. Some employees even end up with pension payments that exceed their final-year salary. A recent *Los Angeles Times* investigation found that even though CalPERS banned the practice in 1993, 20 of California's 58 counties do not participate in the state plan and still allow spiking.

2. Collective bargaining. Government employee unions have a powerful vested interest in bigger government. More government programs mean more government workers, which in turn mean larger union membership rolls. Membership dues go in large part to campaign contributions to politicians eager to expand government. That means collective bargaining in the public sector effectively lets government employee unions sit on both sides of the bargaining table, because the unions spend huge amounts of time and money to elect their own bosses.

Once in office, union-friendly politicians naturally seek to keep their union supporters happy. These elected officials vote fatter pay and benefits to government employees. And the politicians find pensions and other retirement benefits the perfect tool to avoid taxpayer ire, because the future benefits won't come due until the officials have left office, when it will be somebody else's problem.

3. Binding arbitration. Many unions and local governments agree to submit to binding arbitration to avoid strikes, but this process can be even costlier than strikes themselves. An arbitrator will never award a settlement lower than management's final offer; so the union is guaranteed to win at least some of its demands and will never come out worse than the status quo. In this way, arbitration creates an upward ratchet on compensation.

4. Politicized pension fund boards. Overly generous pension commitments have been exacerbated by poor investment management. Take CalPERS. Despite its commendable ban on pension spiking, the fund's management is no paragon of sound investing. Even though the California state constitution requires pension fund managers to choose investments that maximize return and minimize risk, CalPERS board members have pursued their own political agendas under a so-called "triple bottom line," which includes environmental and political objectives unrelated to increasing investment returns. As my Competitive Enterprise Institute colleague Trey Kovacs notes, in 2000, CalPERS stopped investing in tobacco firms, which cost the fund $1 billion in potential gains. In 2008, CalPERS lifted its tobacco ban, admitting that it "could no longer justify" it.

State policy makers should look to pension management in Canada, which *The Economist* recently profiled: "Those seeking to understand how Canadians have pulled it off are given two answers: Governance and pay. There is little political interference in the funds' operations. They attract people with backgrounds in business and finance to sit on their boards, unlike American public pension funds, which are stuffed with politicians, cronies, and union hacks."

5. Faulty accounting standards. Many state pension managers base their funding projections on overly optimistic expectations of investment returns, resulting in too little being set aside for future beneficiaries. This has been allowed to happen under rules set out by the Government Accounting Standards Board (GASB). GASB rules allow public pension funds to calculate their future pension liabilities based entirely on the rate of return they wishfully imagine their investments will achieve. Most pension funds have chosen a rate in the 7 to 8 percent range.

While returns of 7 to 8 percent are achievable in some years, they are not guaranteed every year. Worse, investments that *may* bring higher returns have a higher degree of risk, which translates into more volatility of returns year to year. As Eileen Norcross of the Mercatus Center and Andrew Biggs of the American Enterprise Institute explain:

"Over the past decade, state pension liabilities have been valued using an average discount rate of 7.97 percent. This may seem reasonable, since the median investment return for pension assets over the past 20 years has been around 8 percent. However, returns on market investments are not guaranteed, as the market downturn of 2001-2002 and the crash of 2008 demonstrate. Even if plans accurately predicted average market returns over a very long period, the majority of plans' obligations are payable over the next 15 years, in which average market returns would be more uncertain. There is significant possibility—and in some cases, a probability—that a 'fully funded' plan would be unable to meet its obligations even if the plan accurately projected average market returns."

Pension liabilities by contrast, grow without interruption, year after year. As economists Robert Novy-Marx and Joshua Rauh note, pension fund discount rates should reflect the risks posed by the liabilities. The scholars settle on the U.S. Treasury bond yields, which carry a rate of return that is much lower but much less risky. Those yields averaged 3.36 percent as of mid-2010, and 3.64 percent as of mid-2011. "As a broad rule of thumb, pension liabilities rise by around one-fifth for each percentage point change in the discount rate," explains Biggs. "Thus, a Treasury rate produces dramatically higher liabilities than the 8 percent average discount rate used by pensions today."

The discount rate that pension fund managers use to project future revenues will in turn determine how much contributions they must make today to meet future payout obligations. A discount rate based on high revenue projections allows states to make lower contributions into their pension plans. But when those optimistic projections are not realized consistently, shortfalls result.

6. Defined-benefit pensions. Most states have so-called "defined-benefit" pensions, which guarantee certain benefits to retirees regardless of how the pension plan's investments fare. Most private companies have defined-contribution pensions, where contributions to the pension are fixed and the benefits fluctuate according to the ways individuals invest and draw down their own pension funds. Defined-contribution plans are by definition fully funded and don't run the risk of runaway future liabilities if a plan's hoped-for rates of return don't materialize.

Union Power vs. Reform

As if on cue, nearly every time state and local governments try to rein in public employee pension costs in order to bring their budgets under control, government unions decry such efforts as "scapegoating" of public employees—which is rich, considering that most reforms consist of bringing public-sector pay and benefits in line with those in the private sector who foot the bill.

As the Cato Institute's Chris Edwards notes, "state and local workers have very generous defined-benefit (DB) pension plans compared to private-sector workers. These plans have been overpromised and underfunded, which has created huge long-term gaps in government budgets." One *BusinessWeek* report found state and local pension payouts had increased 50 percent in just five years.

Yet unions oppose even modest reforms. Consider Illinois, which, as the *Wall Street Journal* puts it, "makes California look tough" on government employees' compensation. In April 2012, Illinois Governor Pat Quinn, a Democrat, proposed to increase worker pension contributions by three percentage points (for most state employees, contributions would rise from 8 percent to 11 percent of their pay); raise the retirement age from 60 to 67; and slightly reduce cost-of-living increases. "The changes would be voluntary, though Mr. Quinn wants to rescind retirement health benefits for workers who reject his plan," the *Journal* noted. Unions threatened to sue lawmakers over the proposed reforms.

New Accounting Standards Rock the Status Quo

On June 25, 2012, the Governmental Accounting Standards Board (GASB) voted to approve new government accounting standards that will provide a clearer picture of the liabilities taxpayers across the nation face. By revealing the grimness of the situation, the new standards will heighten the need for bold reforms. The new rules will also weaken defenders of the status quo, who will have a more difficult time pointing to overly optimistic numbers, such as those reported by the Pew Center for the States, whose surveys are widely considered authoritative by policy makers and journalists.

In its latest report on state pension funds' financial condition, also released in June 2012, the Pew Center estimates a nationwide state pension budget shortfall of $757 billion (plus $627 billion for retiree health care costs). But the total pension funding gap may be much larger. As the Pew report acknowledges, "the pension ratings are based on a state's projected investment rate of return, which for most states is 8 percent."

As we've seen, that's not realistic. The more sober Ravitch-Volcker report explains:

"The choice of discount rate is critical. For example, the estimated liability today for a single-year's pension benefit of $31,700, payable 15 years hence, is approximately $10,000 using an 8 percent discount rate, but more than $15,000 using a 5 percent rate. Put differently, using a 5 percent rate increases the estimated liability by about 50 percent relative to an 8 percent rate."

Pew already puts 32 states in the "serious concerns" category, but that is almost certainly too few, because Pew relies on self-reporting by the states, which are not eager to publicize large pension deficits. And again, high discount rates that presume high rates of return on investments encourage riskier investments by desperate pension managers.

"Pew acknowledges that its report uses states' own actuarial assumptions about how much money they expect the pension fund to earn, on average, on investments now and in the future," notes Bob Williams, president of State Budget Solutions and a former auditor with the Government Accountability Office. "The most dangerous deception in the Pew report is the failure to not recognize that public pension funds are putting more taxpayer and worker money into riskier investments at the very time they should be reducing risk as their employees age. That is just setting taxpayers up for a bigger catastrophe in the future."

Although the new GASB rules are not perfect, they will make it more difficult for managers of underfunded public pension plans to continue projecting unrealistic future gains. The new rules allow pension funds that are adequately funded—those that have sufficient assets to pay pensions for both current employees and retirees—to continue forecasting investment returns according to their historic averages, usually around 8 percent. But the new rules decree that pension plans that currently lack sufficient funds to cover their obligations must change to a more realistic discount rate based on projected investment returns of about 3 to 4 percent.

State pension officials are probably not thrilled, because the new rules limit what they can do with the taxpayer money they control. Bigger pension shortfalls and lowered investment income projections both require increased contributions into pension funds. For New Jersey alone, it is estimated, the state will now have to put $5 billion into its pension system in fiscal year 2016, rather than the $3 billion currently budgeted.

While the full impact of the new GASB reporting requirements will not be known for some time, some indications of their fallout are already evident. In Illinois, one of the states facing the most serious pension shortfalls in the nation, the state Teachers' Retirement System is likely to see its already dismal 48.4 percent funded ratio drop to 18.8 percent, way beyond any hope of recovery, the *Rockford Register Star* reports.

Of course, some pension fund managers may try to game the new rules, as a *Wall Street Journal* editorial recently warned. The problem is that plans that are supposedly fully funded would continue to be able to use higher discount rates. This will likely encourage many pension fund managers to engage in additional accounting tricks in order to make their plans appear fully funded. And again, by allowing use of high discount rates, the new GASB rules leave the door open to overly risky investment strategies. As AEI's Andrew Biggs explains in a July 2012 study:

"Like the current rules, the new regulations cement in place the flawed notion that boosting investment risk makes a pension better funded, before a dime of higher returns have been realized. Under the current rules, a pension that shifts to riskier investments can discount its liabilities using a higher interest rate. Under the new rules, a plan that takes greater investment risk can assume its trust funds will last longer and therefore fewer years of benefits would be discounted using lower municipal bond rates."

The Ravitch-Volcker report has similar concerns: "Many analysts have argued that this two-pronged approach has no theoretical basis and is subject to potential gaming; others have welcomed it as an imperfect improvement."

Thus, the new GASB rules, while an improvement, do not go nearly far enough. But things could change more dramatically if the new GASB standard were to become part of a trend toward better accounting of liabilities. One big boost in that direction came July 2, when the credit rating agency Moody's Investors Service announced it will start valuing pension debt according to its own new methodology, based on the Citibank Pension Discount Curve, which private-sector pension plans use to value their liabilities.

For 2010 and 2011, the first years for which Moody's plans to apply its new reporting standards, the yield average was 5.5 percent. As of June 30, 2012, notes AEI's Biggs, the average 15-year bond yield was 3.9 percent, while the 20-year yield was 4.1 percent. Moody's new approach would mean the nationwide unfunded pension deficit is $2.2 trillion—approximately triple the Pew estimate. For just Illinois, it would mean an increase in debt from $83 billion to nearly $135 billion.

The question now facing taxpayers around the country is how those increased shortfalls will be addressed. Recent history suggests that as the numbers for states' pension deficits grow larger, reform in many states tends to accelerate, with some acting as boldly as Utah and Rhode Island have already.

Rhode Island Points the Way

Rhode Island's reforms remind us that politicians across the political spectrum must bring public employee compensation under control. Deficits bear no party label; so lawmakers across the nation, both Republican and Democrat, have begun working to address their pension liabilities with varying degrees of boldness. This has required taking on government employee unions, which has created considerable friction between the unions and their traditional Democratic allies. Many Democratic lawmakers' reform proposals have not been as far-ranging as those put forth by their Republican counterparts, but deeply blue Rhode Island is a notable exception. In fact, the Ocean State's pension reforms are some of the boldest in the nation.

In August 2011, the City of Central Falls, Rhode Island, about six miles north of Providence, declared bankruptcy. In state receivership for a year at the time, the city could not afford to pay $80 million in retirement benefits to 214 police officers and firefighters—an average of around $373,000 per retiree. In November 2011, the Rhode Island legislature, seeking to avoid a repeat of that scenario, approved a huge overhaul to the state's pension system. Governor Lincoln Chafee, an independent and former liberal Republican, signed the bill into law on November 18, 2011.

The pension reform shifted all state workers from defined-benefit pensions to hybrid plans that include both a guaranteed annuity and a defined contribution component. Significantly, Rhode Island's reform is the first to apply to current as well as future employees. The reform law also raises the retirement age from 62 to 67 and suspends cost of living increases until the pension system—which was only 50 percent funded at the time of the reform—reaches a more appropriate funding level.

Then in April 2012, Rhode Island State Treasurer Gina Raimondo, who designed the state's pension overhaul, convinced the state pension board to reduce the discount rate the state uses to calculate its pension liability from 8.25 percent to 7.5 percent. The *Wall Street Journal*'s Allysia Finley, who interviewed Raimondo last March, notes that Raimondo "claimed that 7.5 percent was a more honest number since the actual investment return rate over the last decade was 2.28 percent." Obviously, the lower discount rate remains far too high, though it is a step in the right direction.

Now Rhode Island Governor Lincoln Chafee is working to help cities in his state get a handle on their pension costs, which have already done enormous damage.

Utah Pension Reform

Describing pension reform, Utah State Senator Dan Liljenquist put it best: "This is not a conservative-versus-liberal issue, this is a reality issue." Liljenquist helped his state face up to the reality of its underfunded public employee pensions by leading a successful reform effort.

Utah's state pension fund was severely hit by the financial crisis. It lost 22 percent of its assets during 2007-2009. Its funding ratio fell from 95 percent to 87 percent—better than many other states, but still a significant drop. One major component of Utah's pension reform was based on the old truth that if you are in a hole, the first thing to do is stop digging.

The Utah legislature, during its 2010 session, passed Senate Bill 63, which closed the existing defined-benefit pension plan to new employees, giving them the option of a hybrid plan or a defined-contribution 401(k)-style plan. For new employees, the state will contribute 10 percent toward their retirement plans, a fixed and predictable amount.

Brigham Young University economics professors Kerk L. Phillips and Richard W. Evans estimate that without the reform, Utah's pension fund would have faced a 50 percent chance of becoming insolvent by 2028. Thanks to the reforms, Utah is now on track to cut its $6.5 billion pension gap by half. Still, "even with reform, defined-benefit pension programs will always pose a risk of insolvency and some type of painful policy change."

Conclusion

The Ravitch-Volcker report notes that the Obama administration's 2009 "stimulus" bill provided "substantial temporary relief" to states straining under heavy pension burdens, but that relief only "allowed states to delay decisions that they must make now, in light of the slow economic recovery." In other words, pols and their unionized contributors have happily kicked the pension can down the road for years, but now there is not much road left.

The overall fiscal picture has worsened so that now states and localities with huge pension shortfalls have been forced to make cuts to public services. As a result, taxpayers are saying "Enough." Pension reforms, such as the ones that government employee unions loudly protested against in Wisconsin, are spreading to the rest of the nation—even to Democratic-leaning states with high unionization rates. On June 5, 2012, the same day in which Wisconsin Governor Scott Walker survived a union-sponsored recall election, voters in the California cities of San Diego and San Jose approved pension reform measures that reduced benefits for city workers.

For union-friendly elected officials and the government union labor bosses who support them, the party may not be over yet, but it certainly looks like it's beginning to wind down. When it does finally end, taxpayers will endure a long and painful hangover.

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LaborNotes

The **National Labor Relations Board** (NLRB) “has experienced ideological swings throughout its existence depending on the party in the **White House**,” writes the lawyer who represented **Boeing** in its recent NLRB case over a new plant in **South Carolina**. “But the degree of change and the willingness to ignore statutory language and judicial precedents is unique to the current administration.” For example, last fall the NLRB “reversed decades of precedent to allow unions to organize ‘micro’ bargaining units” such as the recently certified bargaining unit “consisting of the women’s shoe departments on the third and fifth floors of **Bergdorf Goodman**’s store in New York City.”

The **Louisiana Association of Educators**, a teachers’ union, is fighting furiously against the state’s new voucher law. It had its lawyer send threatening letters to private and parochial schools warning it would sue any school that accepted state funds. Attorney **Brian Blackwell** demanded that every private or parochial school either quickly send letters to him and to the **Louisiana Department of Education** refusing the funds, or “we will have no alternative but to institute litigation.”

Government schools in **Highland Park, Michigan**, have added financial collapse to educational failure. Only 22 percent of the district’s third-graders could pass state reading exams in the last school year, and that was the good news. A mere 10 percent of the same students could pass state math exams, while years more time in the system made students even worse: The percentage of high schoolers who passed reading was half that of third graders, and 0 (yes, zero) percent of high schoolers passed in math. Quite a return on investment for the $16,508 the district spent per student the same year, a sum that was more than $7,000 above the state average. Meanwhile, the district achieved an $11.3 million deficit over and above its $18.9 million budget. In desperation, and much to the chagrin of its teachers’ unions, Highland Park has decided to outsource all of its schools to **Leona Group LLC**, a private, for-profit charter school company. Although this company typically receives far less per-pupil funding than government-run schools enjoy, students in 19 of the 22 Michigan schools Leona already runs meet state standards.

The city of **San Bernardino** recently joined its fellow **California** city of **Stockton** in declaring bankruptcy, thanks to a deficit of $45 million on a $130 million budget that left it unable to pay vendors or city workers. Its biggest creditors, workers and retirees, “have been unwilling to renegotiate contracts and benefits,” observes the *Wall Street Journal* editorial page. This intransigence has led to the city’s bankruptcy, even though it has slashed its workforce by 20 percent over the last four years. The city “projects $45 million annual deficits for the next five years,” which means additional cuts to city services that “could endanger public safety and cause an exodus of residents.”