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FIXING THE PUBLIC SECTOR PENSION PROBLEM: The (True) Path to Long-Term Reform

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Executive Summary

Even as the federal government struggles to stabilize its finances, many states are facing their own daunting sets of fiscal deficits. These take the form of unfunded liabilities totaling almost $1.4 trillion and stemming from obligations to pay for public employees' pensions, retiree medical insurance, and other retirement benefits. Reform efforts ostensibly being made to solve this crisis have fallen short.

These "reforms" include:

1) Issuing new bonds to refinance existing liabilities. But these merely add to the total sum of indebtedness, and the capital they raise is subject to raids serving other purposes.
2) Adopting new or modified defined-benefit plans that create new risks for current and future taxpayers. Optimistic investment-return assumptions further mask the true magnitude of these deficits.
3) Assigning existing unfunded liabilities to younger, more recently hired workers, whose own benefits will likely prove unsustainable as their salaries rise.
4) Early-retirement incentive plans. But these often turn out to be expensive, hampering productivity while not achieving long-term objectives.

Because governments must use taxpayer money to make up any shortfalls, they have an incentive to overstate the contribution that future investment gains will make to the holdings that ultimately fund retirees' benefits. Such practices are commonplace. An assumed rate of return that reflects lower future market expectations would reveal cumulative deficits even more yawning than those currently estimated.

The necessity for real reform is problematic for policymakers, who must deal with a workforce resistant to the loss of guaranteed monthly pension benefits; and for political constituencies, including government workers and their allies, whose support for defined-benefit pensions in the public sector stems as much from ideology as from financial self-interest. This is a balancing act that leaves policymakers with few politically popular choices. Yet politicians' current approach to evading such opposition—that of adopting incremental reforms while repeatedly deferring liabilities—is no longer viable.

Systems that continue to add workers to their defined-benefit plans, which obligate them to make fixed benefit payments, have mitigating steps available to them in many cases. Such steps include:

1) Reducing as-yet-unearned benefits.
2) Increasing the age of retirement or modifying early-retirement provisions.
3) Moderating or eliminating pension cost-of-living adjustments.
4) Increasing the financial contributions that workers must make to the plans.

While governments confront very steep legal obstacles to extricating themselves from obligations already incurred, they can free themselves from the political pressures, crystal-ball gazing, and monumental financial risks that defined-benefit plans make almost unavoidable. They should take a page from the private sector and shift to defined-contribution plans. Under such plans, to which employees as well as employers may contribute, investment risk is borne by plan members, not by taxpayers. A majority of Fortune 100 companies have already adopted such plans. Only 16 percent of large companies still offer their retirees medical coverage.

By sharing a complex of risks with the beneficiaries, states and municipalities would be able to devote far more of their time and resources to the more immediate concerns of today's voters and taxpayers.

About the Author

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BACKGROUND

At the same time that the federal government is wrestling with the debt it has run up, which has come to be measured in the tens of trillions of dollars, the states are facing their own daunting sets of fiscal deficits, which take the form of unfunded liabilities. The Pew Center on the States recently estimated their total, representing public employees' pensions, retiree medical insurance, and other retirement benefits, to be over $1.38 trillion,[1] according to FY 2010 data, the last year for which data are available, and it is likely that subsequent reports will reveal further increases. This total comprises $757 billion posed by defined-benefit pensions and $627 billion by other post-employment benefits (OPEB), which include retiree health-care plans.

This is the current value of amounts owed over and above any dedicated assets already accumulated within the various employee-benefit trust funds. Such deficits are growing daily with interest. Pew reports that 38 states have OPEB liabilities that are less than 10 percent funded, effectively putting their plans on a pay-as-you-go basis.[2]

Separately, an October 2012 study, prepared by the actuarial consulting firm Milliman,[3] of the 100 largest public-sector defined benefit plans,[4] estimated the current deficit to be $1.193 trillion,[5] representing only 67.8 percent of the amount currently needed to provide benefits for present and future retirees enrolled in the plans. These figures are predicated upon an optimistic annual rate of return on assets of 7.65 percent.

Such findings are evidence that the current defined-benefit pension system, which provides formula-based monthly payments to beneficiaries, is unsustainable. Many states that have touted their plan-design reforms find themselves facing the necessity of additional measures sooner rather than later.

The Wall Street Journal reported in September 2012 that the reforms adopted by many states have fallen short of significantly reducing unfunded liabilities, which now total approximately $800 billion and are likely to grow. [6] Not surprisingly, Moody's recently reiterated its negative outlook on the states for the fifth consecutive year and currently reports a negative outlook on nine states.[7]

An example is Pennsylvania, where, despite changes to the state's two largest pension systems affecting new hires, which were adopted in 2010, the systems' solvency has been further undermined. By reducing the assumed rate of return on assets from 8 percent to a slightly more realistic 7.5 percent, the state added over $6 billion in new liabilities. Additional measures instituting proper funding policies and including a defined-contribution plan will need to be considered in 2013. "Governor Tom Corbett has compared the state's growing liabilities to a PacMan poised to chomp away at the rest of the state's budget."[8]

Comprehensive pension reform entails coupling a transition to defined-contribution plans, such as a 401(k), with equally important funding reforms. These involve ensuring that pension benefits are funded as they are earned, so as to avoid assigning existing and future deficits to the next generation of employees and taxpayers.

The necessity for such changes is problematic for policymakers, who must deal with a workforce resistant to the loss of guaranteed monthly pension benefits, and political constituencies, including government workers and their allies, whose support for defined-benefit pensions in the public sector stems as much from ideology as from financial self-interest. This is a balancing act that leaves policymakers with few politically popular choices. Politicians' current approach to evading such opposition—that of adopting incremental reforms while repeatedly deferring liabilities—is no longer viable. There are daily reports of bond-rating downgrades, bankruptcy filings, and pessimistic long-term financial analyses. U.S. cities, in particular, are in increasingly dire financial straits.[9] The current path is unsustainable.

THE DEFINED-BENEFIT PENSION PLAN AND THE CASE FOR REFORM

A defined-benefit pension plan provides a "definitely determinable benefit," or, in layman's terms, a monthly benefit based upon a predetermined set of formula(s) typically reflecting a member's pay and years of service. (In the public sector, such plans generally require contributions by participants.) These plans require an actuarial valuation that informs the plan sponsor of what the periodic employer contributions need to be. Whether these employer contributions are actually made is a separate matter. These member and employer contributions, together with investment earnings, are intended to provide sufficient accumulations of capital to properly fund current and future benefits. The investment risk lies predominantly with the plan sponsor, which is liable for any shortfalls.

In contrast, a defined-contribution plan is one to which the employee and generally the employer make regular contributions. The resulting accumulations finance future retirement benefits. The participant can invest in any of a set of investment funds made available by the employer. Investment decisions and the associated risks and returns reside with the plan participant.

There are certain variations on these basic plan designs; in some cases, the terminology can cause confusion. The term "hybrid plan," for example, is used to encompass many dissimilar arrangements.

Sometimes the term refers to cash-balance plans, which are another form of defined-benefit plan, in which the accrued benefit is expressed as an account balance. Here is how such a plan was recently described: "And then there have been Republican innovators like Louisiana Gov. Bobby Jindal, who in June signed legislation to move new state hires into *the sort of 401(k)-style* retirement plan that will finally allow states to manage their long-term liabilities" (emphasis added).[10]

Of the many state and local governments wrestling with these long-term pension and OPEB liabilities, some have implemented changes, while others have gone no further than mentioning reform as an important policy priority. Such a variety of largely inadequate responses raises the questions of who and what defines pension reform and against what standards the results are to be measured.

Some states describe their efforts as "incremental" pension reform. In Pennsylvania[11] and New Jersey,[12] recent reforms perpetuate the problem of underfunding. Other states, including Rhode Island[13] and Utah,[14] reamortized (deferred) existing unfunded liabilities. Many of these plans assume optimistic annual asset returns of 7.5 percent (or higher), posing the risk that the cost of covering shortfalls will be legislatively assigned to future generations.

What are the elements of pension reform? This paper subjects nominal efforts at reform in various states to a systematic set of criteria, devoid of political considerations. It first explains why certain kinds of so-called reform measures do not deserve the designation. These feeble attempts, which are all too much in evidence, often do little more than temporarily mollify voters and other critics while deferring liabilities. In some cases, these efforts are too little and too late and further reduce funding.

This paper focuses on defined-benefit pension systems, while recognizing that significant reforms are also needed in the design and funding of OPEB, such as retiree health-care plans. OPEB are distinct from pension benefits, yet they similarly lack affordability or the demographics to support them adequately. Indeed, most OPEB arrangements proceed on a pay-as-you-go basis, meaning that they are not prefunded and, as such, possess significant unfunded liabilities. A further risk to plan sponsors involves uncertainties in the nation's health-care system, the unpredictable number of those retiring before they are old enough to qualify for Medicare, and the nature and extent of reforms to programs such as Medicare and Social Security.

Some observers are predicting that municipal deficits, culminating in bankruptcy, will become state—and ultimately, perhaps, federal—obligations. Unfortunately, given the size of the federal government's deficits, it is hardly in a position to offer help, and some would maintain that principles of federalism should preclude such a step.

FIVE PENSION "NON-REFORM" REFORMS

The pseudo-reforms undertaken in recent years can be organized into five categories. They are listed below and are summarized in the chart on page 5.

It is, at best, a half-truth that enrollment of new members in defined-benefit plans can sustain such plans if the new members bear their proportionate share of the unfunded liability. The problem with this line of reasoning is that proper funding is achieved when benefits are funded as they are earned. A policy of transferring costs attached to one set of beneficiaries to yet another cannot be justified unless one believes that an amortization period can be perpetual, since government entities like states—unlike companies—don't go out of business. A 2004 report issued by the state of Pennsylvania actually made such a claim: "Full funding may be a necessary standard for a private plan, but it is not necessary for a public plan because a public entity can assume perpetual life."[15]

1) Pension Obligation Bonds

Some officials contend that issuing pension obligation bonds or using other debt-leveraging techniques can be an effective financing scheme for reducing unfunded liabilities. This technique involves borrowing funds at a low interest rate (around 4 percent) to earn an assumed return of around 8 percent on the proceeds deposited within the pension fund. Even if one accepts the logic of this risk-arbitrage strategy, there is a natural political predisposition over time to separate the bond from the newly fortified pension plan. Not surprisingly, the frequently observed result is the subsequent and sometimes retroactive enrichment of pension benefits with this new influx of capital. Further complicating matters is that many pensions fail to achieve their targeted rate of return.

About pension obligation bonds, former New Jersey governor Jon Corzine remarked in 2008: "It's the dumbest idea I ever heard. It's speculating the way I would have speculated in my bond position at Goldman Sachs…. It's lousy public policy."[16]

2) Early Retirement Incentive Plans

By offering a financial incentive, these plans induce members of a particular group to elect retirement. Such initiatives are generally designed to reduce staffing levels, often as part of an overall fiscal reform plan. The incentive often involves, but is not limited to, an enhanced pension benefit. Such enhancements, if paid through the retirement plan, inevitably result in an unplanned increase in plan liabilities. Often an accompanying goal is to reduce head count or to expand opportunities for younger employees.

The question of whether such approaches are cost-effective is generally answered by identifying the targeted "backfill" rate: that is, the percentage of retiring employees that are replaced. While the variables of any particular initiative can vary considerably, a rule of thumb is that not more than 40 percent of the retirees should be replaced, if this tactic in net terms is at least to break even. Backfill rates in the range of 80–100 percent are generally not cost-effective, in the experience of this author, unless unusual circumstances exist. An important question is whether the anticipated savings are illusory, since the lower-paid employees assuming these new responsibilities are presumably less productive than the retiring, higher-paid employees they are replacing.

3) Reamortizing the Unfunded Liability

This is a favorite financial tool of pseudo-reformers, since it can assist in propagating the illusion that current costs are manageable. It is often accompanied by the amorphous characterization of a plan as "actuarially sound." The strategy effectively defers some or all of the existing deficits while assigning the unaffordable liabilities to the next generation of taxpayers and employees. Some plans even decide every year to assign (the technical term is "fresh start") the unfunded liability to a new payment period of up to 30 years, thereby creating rolling amortization schedules, perhaps in perpetuity. Typically, plans that resort to such tactics also assume annual returns in the neighborhood of 7.5 percent. There are many variations on this basic theme.

Such practices will be more closely scrutinized in the future by the financial community, given the mandatory compliance of state and local municipal deficits with the newly promulgated Statements 67 and 68 of the Government Accounting Standards Board (GASB), which will require greater disclosure. In addition, unfunded liabilities will appear on the balance sheets. The provisions of Statement 67 are effective for financial statements for fiscal periods beginning after June 15, 2013. The provisions in Statement 68 are effective for fiscal years beginning after June 15, 2014. Earlier application is encouraged for both statements.[17]

4) Politics and Defined-Benefit Plans

Politics and defined-benefit plans are a toxic combination. For the purposes of this paper, politics means forces within the pension system responsible for the following actions, which can be carried out singly or in combination, in single years or repeatedly:

a) The tendency of plan sponsors and fiduciaries (typically influenced by elected officials and plan participants) to promise and perpetuate retirement benefits that are generally benchmarked only against other public-sector pension systems rather than their counterparts in the private sector

b) The use of rosy economic assumptions to minimize current and future costs

c) The failure to contribute the actuarially recommended contribution

d) The deferral of costs so as to avoid raising taxes, or the direction of funding away from favored line items in the annual fiscal budget

e) Postponing the attainment of a 100 percent funded ratio to a time well beyond the average remaining career span of the current workforce

f) Retroactively improving benefits

g) Granting ad hoc benefit improvements

Although it can be argued that defined-contribution plans are also susceptible to the influence of politics in the form of varying the size of an employer match or discontinuing it, the same powerful incentives do not exist to do so.

5) "Hybrid plans" and other types of pension plans

As previously discussed, "hybrid plan" can refer to defined-benefit plans in which the accrued benefit is expressed as an account balance. Such plans are commonly described as "cash balance" pension plans. Admittedly, they are hardly immune from the political foibles enumerated above. Cash-balance plans have been commonplace in the private sector for many years. However, such plans have been largely replaced by defined-contribution pension plans because of the unpredictability of employer costs and thus, often, their unaffordability, since employers must make up shortfalls in asset performance. For example, for 2005 and beyond, IBM discontinued its cash-balance plan for new hires in favor of a 401(k) plan.[18]

The term "hybrid" can also describe arrangements in which defined-contribution and defined-benefit plans are offered as separate, stand-alone plans.

SUSTAINABLE AND COMPREHENSIVE REFORM

Large companies over the past couple of decades have been replacing their defined-benefit plans with defined-contribution plans. This shift is occurring because plan sponsors have lost faith that the former are able to achieve costs that are:

1) Predictable
2) Affordable
3) Current (no unfunded liabilities)

Predictable costs are those generally expressed as a standard percentage of current or future payrolls. A plan is affordable if its costs correspond to those posed by a comparable labor pool in the private sector. If the public workforce's salaries and benefits are more generous than what is found in the private sector,

Pseudo-Reforms

Item	Why it is a problem
1) Using pension obligation bonds or other borrowing strategies to finance retirement benefit systems	Increases risk to taxpayers by offering the resources to increase pension benefits
2) Early retirement incentive plans	Enhances already generous benefits; long amortization periods; a false economy
3) "Fresh start" (reset) of any unfunded liability beyond the average remaining duration of workers' careers Other funding techniques that defer costs, including assigning such costs to new employees	A political dodge that burdens future generations
4) A new and reduced DB plan and/or an optional DC plan	Neither will escape the politics of public pensions
5) A new cash-balance (hybrid) plan or a reduced set of new DB and DC plans	Same politics and funding problems of defined-benefit plans

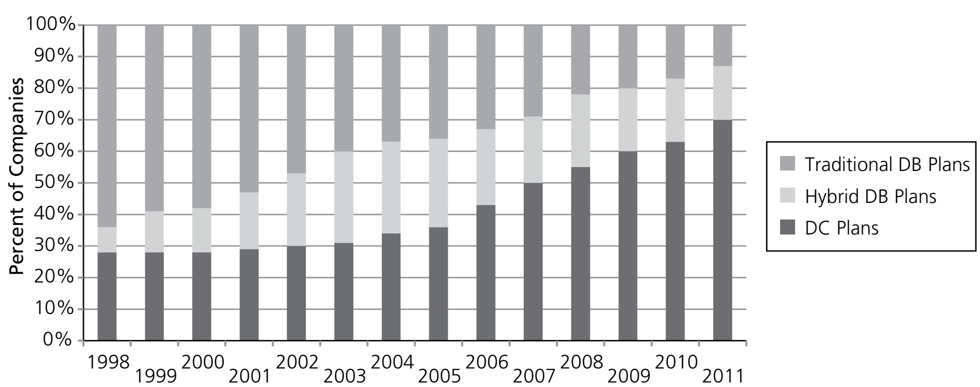
they are unlikely to be reasonable or affordable for taxpayers. Such a comparison is important because the public sector is ultimately dependent upon the private sector as its source of funding. Often, however, the benchmark is other public defined-benefit pension systems, frequently those with unfavorable financial profiles. Moreover, many comparisons unrealistically assume an annual return on assets of 7.5 percent or higher.

Finally, a plan needs to be current, which means that benefits should be funded as they are earned and fully "paid up" at retirement, thereby achieving a funded ratio[19] of 100 percent. Since pensions represent deferred compensation and their purpose is to replace income at retirement, such an imperative is only sensible. The sums as they accumulate need to be systematically set aside so that they can ultimately support future payouts. Deferral of funding for a period extending well beyond the beneficiaries' date of retirement destroys the logic and soundness of this financial model, translating it effectively toward a system of pay-as-you-go. So what if the current benefit recipients are aware of this evasion? It still represents a transfer of costs to the next generation. A recent publication[20] of the American Academy of Actuaries stands up for full funding of already-incurred obligations. According to senior pension fellow Don Fuerst: "Somehow 80 percent has become a perceived standard but that is a myth we need to replace with facts."

Sadly, many politicians involved in overseeing public-sector defined-benefit plans lack a consistent approach to the three principles just enumerated. The tendency of plan sponsors to favor long-term irresponsibility over short-term pain and an honest accounting of the scope of a system's obligations is documented: "Pittsburgh pension board members refused [on August 23] to consider lowering the fund's annual investment-earnings projection [from its current 8 percent level], saying the move would require increased cash contributions each year that the city could fund only on the backs of employees or with a tax increase."[21]The structural defects of defined-benefit plans, as well as their implication in a system of decision making impaired by political considerations, necessitate a wholesale shift from defined-benefit to defined-contribution plans. Despite fewer such pressures in the private sector, many Fortune 100 companies have made the switch. The pattern of change is depicted in the chart below. These companies are generally leaders in pay, benefits, and human-resources practices as a whole.

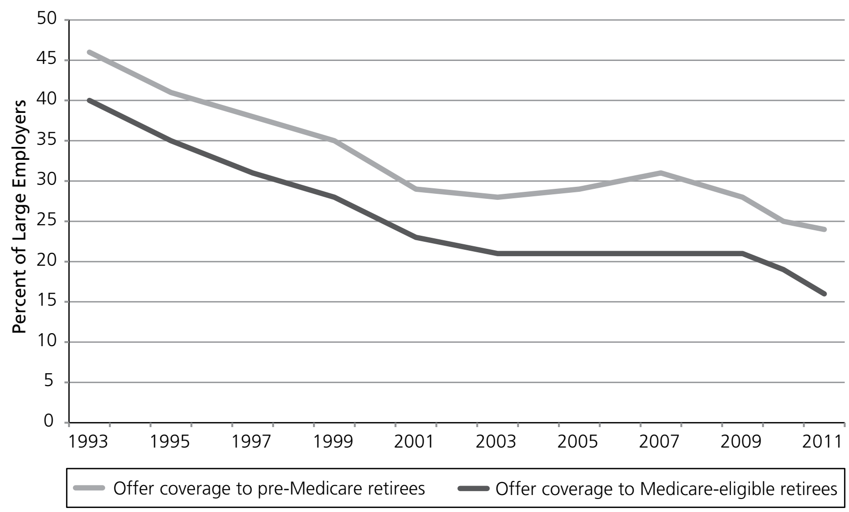
Closely related to the decline of defined-benefit pension benefits is a decline in OPEB (principally, retiree health-care plans). Shown below are the results of the 2011 Mercer National Survey of Employer-Sponsored Health Plans on the prevalence of employer-provided retiree health-care coverage by 2,844 employers.[23] A lack of predictability and affordability, together with

Fortune 100 Companies – Trends in Retirement Plans



2011 Towers Watson Survey
Average Cost to Employers of Defined-Contribution Plans[22] (4.77 percent to 7.67 percent of pay)

Offerings of Medical Plans for Medicare-Eligible Retirees Drop to 16 Percent of Large Employers



Source: Mercer's National Survey of Employer Sponsored Plans

other factors, has led to a decline in the number of these programs as well.

A FIVE-POINT PLAN FOR COMPREHENSIVE REFORM

Described below is a five-step template for achieving comprehensive and sustainable pension (and OPEB) reform. It is not meant to preclude a process of refinement, as lessons are learned and policies are adapted to new circumstances. Administrative costs should decline as the process unfolds.

In many states, the annual actuarially recommended contribution represents an amount greater than a government entity wishes to contribute. Generally, underfunding carries few, if any, consequences other than an obligation to repay with interest at a later date, which only adds to ever-increasing deficits. For fiscal year 2010, the Pew Center on the States reported that 31 states contributed less than 100 percent of the actuarially recommended contributions to their major pension plan(s), with the three lowest states being Pennsylvania (29 percent), New Jersey (32 percent), and Washington (53 percent).[24] This continuing practice will likely be sustained in subsequent years.

Therefore, pension contribution levels are often predictable and affordable, but few, if any, plans are current—that is, reflecting a 100 percent funded ratio. Plans falling below this threshold are unlikely to meet it even in 15 years or in whatever period the underlying demographics of the plan would seem to support full funding. Even those plans that have a funded ratio of 100 percent (or better) may not be fully funded, since many assume overly optimistic rates of return on assets.

Some actuaries have suggested that perpetual pension deficits are almost desirable, since the prospect of a 100 percent funded ratio encourages politicians to further enrich benefits packages. Irresponsible public officials will, in some cases, proceed with such enhancements despite their aggravating effect on deficits already accumulated.

A defined-contribution plan with costs of 4–7 percent of payroll, by contrast, will ensure that employer costs for new hires are not only predictable and affordable but current as well, having eliminated any possibility of unfunded liabilities imposed by them. This is the important first step. The state of Michigan, for example, enrolled its new hires in a defined-contribution plan in 1997. Doing so saved over $2.3 billion.[25]

While an intensive discussion of appropriate retirement-replacement ratios (the percentage of pre-retirement earned income replaced by pension income) is beyond the scope of this paper, setting a proper ratio is the first step in enacting pension reform. One study suggests that combined employee and employer contributions in the range of 12–15 percent[26] of earned income should provide an acceptable standard of living in retirement, while another study suggests that 10–16 percent[27] would be the proper ratio. For those not yet covered by Social Security,[28] the suggested target is 18–20 percent.[29] As noted, the uncertainties dealing with inevitable reforms required in federal entitlement plans such as Medicare and Social Security will affect retiree health-care plans and are a significant factor in determining an appropriate level of retirement income.

The second step involves prohibiting the creation and issuance of new debt to finance existing liabilities, typically by issuing pension obligation bonds.[30] Legal and financial minds might resort to other, equally unacceptable, creative techniques.

The third step is arranging adequate funding by reducing, if not eliminating, unfunded liabilities and improving funded ratios, an unpalatable measure for officeholders because it does not yield an immediate political payoff. Benefit improvements resulting in funded ratios falling below 90 percent should not be considered. A good starting point is to make funding policies generally consistent with the recently adopted GASB Statements 67 and 68. They call for using amortization periods that take into account the demographics of the underlying population. By way of illustration, if the average age of a working group is 45 and it is assumed that its members retire, on average, at age 60, then any plan deficits (unfunded liabilities) funded over periods of up to 15 years would be appropriate. Another aspect of this accounting rule requires that plan assets be valued on the basis of their fair market value at a given moment in time instead of on the basis of some other criterion, such as rolling yearly averages. The choice of a proper funding interest rate could and should be lower than the present norm of 7.5–8 percent. The volatility and thus predictability of asset performance, plus other variables such as increased longevity, are further reasons to shift to a defined-contribution plan, in which the plan participant assumes the investment risk. The alternative is inflicting these costs on the next generation, which is already burdened with a myriad of other legacy costs.

The fourth step involves reducing benefits that have not yet been earned by enrollees who are still working. Doing this would include, but not be limited to, increasing member contributions, raising normal and early-retirement ages, reducing or eliminating pension cost-of-living adjustments (COLAs), and prohibiting deferred retirement optional plans (DROPs), which permit an individual to be effectively employed and retired at the same time. Since prevailing statutes and labor practices vary by state, such a strategy needs to be developed accordingly.

The fifth step is to implement this comprehensive strategy without increasing taxes.

An accompanying initiative should reform the design and unreliable financing of retiree medical plans, since these unfunded liabilities are nearly as large as those of public pensions.

PENSION "TRANSITION COSTS" IN MOVING FROM DB TO DC PLANS

As mentioned, the amortization periods of unfunded liabilities generally span durations that are insufficiently supported by the underlying demographics of the plan in question, effectively transferring costs to the next generation. In addition, many funding schedules are based on a constant percentage of pay, which effectively backloads the contribution schedule, since annual contributions will increase along with the size of future payrolls. In a level-dollar payment schedule, which characterizes most fixed-rate mortgages and

A Five-Point Plan for Comprehensive Reform

1. **Establish defined-contribution plans.**
   – Eliminates unfunded liabilities
   – Removes politics from pensions
   – Eliminates long-term taxpayer obligations
2. **Prohibit state issuance of pension obligation bonds, post-employment benefit bonds, and other such forms of financing.**
   – Prevents deferment of liabilities and exploitation of future generations
3. **Adopt pension funding reforms that advance the goals of accounting stan dards GASB Statements 67 and 68, so that benefits are funded as they are earned.**
   – Shorter amortization periods, use of market value of assets
   – An annual employer cost of 4–7 percent of payroll
   – Prohibit benefit improvements resulting in a funded ratio below 90 percent
   – Presence on balance sheet of unfunded liabilities
4. **Modify unearned pension benefits.**
   – Increased member contributions
   – Reduced formula benefits
   – Increased normal retirement age
   – Curtailed early-retirement subsidies
   – Reduced or curtailed pension COLAs
   – Reduced OPEBs
   – No more DROPs
5. **Improve the funded status of plans without increasing taxes.**

other types of consumer loans, by contrast, payments are constant.

Shortening the amortization period would by itself increase the annual contribution in the manner of a mortgage, for which annual or monthly payments are greater in those that mature sooner (other factors, such as interest rate, being equal).

The transition from a defined-benefit to a defined-contribution regime presents its own set of challenges. Any existing unfunded liability in the former will need to be paid off, and usually more quickly than it would have had to be if the plan were retained. Such shortening can influence the sponsor, in consultation with the actuary, to revise the assumed interest rate downward, especially if it is overly optimistic. The impact will be to raise the size of the sponsor's contribution to compensate for the smaller contribution resulting from the slower expected appreciation of assets. Such matching should be the hallmark of every plan. To characterize any of these funding reforms as imposing new costs mistakenly implies that accelerated and more timely contribution schedules are doing something beyond matching assets to liabilities.[31]

Some observers contend that the accounting treatment of a level-dollar amortization schedule of a closed defined-benefit plan demanded by GASB entails an increase in contributions. A recent study by Robert M. Costrell debunks the myth that the conversion of a defined-benefit to defined-contribution plan incurs such a "transition" cost.[32]

CONCLUSION

Simply stated, we need to avoid pseudo-reforms in their entirety in favor of the five recommended actions designed to achieve comprehensive and sustainable reform. Specifically, annual employer pension costs should be targeted at 4–7 percent of payroll, or at a level consistent with patterns established in the private sector.

Most reform initiatives focus on new hires. But these reforms do little or nothing to reduce existing unfunded liabilities. Yet improvements can be achieved by reducing unearned benefits for existing participants, increasing the age of retirement, and modifying cost-of-living adjustments for current or future retirees, for example.

Benefits should be funded as they are earned, partly because unfunded liabilities are always at risk of increasing beyond forecasts, to the extent that expected investment returns and other actuarial assumptions are not achieved. However, such a structure carries a low political rate of return. Unhelpful plan-design changes are, regrettably, often accompanied by great fanfare. By contrast, a deferral of existing deficits and other deceptive techniques resulting in an immediate but temporary reduction in costs usually receive little scrutiny. The more responsible course risks jeopardizing the funding of a favorite current program or making an unpopular tax increase inescapable. The people who will bear the brunt of such deferred maintenance are often too young to object at the ballot box.

We can expect bond-rating agencies to examine such practices more closely than they have in the past and the states themselves to disclose them more fully under pressure from the recently revised GASB accounting standards, which require the unfunded liabilities of public-sector defined-benefit plans to be placed on the balance sheet of the public entity sponsoring the plan. In addition, GASB will require most pension costs to be recognized over shorter durations than is now the case.

The funding problem is so acute that some have even proposed a role for the federal government in underwriting states' and cities' pension costs. One need not look further than the Pension Benefit Guaranty Corporation and its billions in deficits from guaranteeing portions of private-sector defined-benefit pensions to see that such guarantees seem to introduce moral hazard. Deficits within Medicare and Social Security, on top of the deepening national debt, pose risks of their own. We are on an unsustainable trajectory that requires immediate and comprehensive action for the sake of future generations.

Endnotes

[1] See http://www.pewstates.org/research/reports/the-widening-gap-update-85899398241.

[2] The decisions in certain states to adopt pay-as-you-go funding can also be affected by legal opinions or policy practices that such benefits can be unilaterally modified if not discontinued immediately. Some believe that prefunding would confer legal rights on these same benefits, thereby making it more difficult to modify such arrangements.

[3] See http://publications.milliman.com/publications/eb-published/pdfs/2012-public-pension-funding-study.pdf.

[4] Based upon the most recent actuarial valuations from June 30, 2009, to January 1, 2012.

[5] Using the market value of assets.

[6] See http://professional.wsj.com/article/SB40000872396390443890304578010752828935688.html.

[7] See http://in.reuters.com/article/2012/09/19/moodys-states-outlook-idINL1E8KJA9M20120919.

[8] See http://www.newsworks.org/index.php/local//harrisburg/43810-lawmakers-confront-massive-shortfall-in-pa-pension-funding.

[9] See n. 1 above.

[10] See http://online.wsj.com/article/SB10000872396390444812704577609432855449486.html?mod=WSJ_Opinion_LEADTop.

[11] See http://www.commonwealthfoundation.org/research/detail/13-reasons-to-oppose-hb-2497.

[12] See http://www.nj.com/news/index.ssf/2011/10/christie_fix_didnt_save_nj_pen.html.

[13] See http://www.pensionreformri.com/docs/index.html.

[14] See http://le.utah.gov/interim/2010/pdf/00001430.pdf, executive summary, finding no. 6.

[15] See http://jsg.legis.state.pa.us/publications.cfm?JSPU_PUBLN_ID=48, p. 20.

[16] See http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arYeVtZeBd4s.

[17] See http://www.gasb.org/cs/ContentServer?pagename=GASB/GASBContent_C/GASBNewsPage&cid=1176160126951.

[18] See http://www.washingtonpost.com/wp-dyn/articles/A49863-2004Dec8.html.

[19] This is the ratio of a plan's current assets to the present value of earned pensions. Detailing the variations in the definitions of assets and liabilities are beyond the scope of this paper.

[20] See http://www.actuary.org/content/actuaries-debunk-myth-80-pension-funded-ratio-alone-constitutes- percentE2 percent80 percent98actuarially-sound percentE2 percent80 percent99-recommen.

[21] See http://www.post-gazette.com/stories/local/neighborhoods-city/city-pension-board-rejects-studying-realistic-returns-650328.

[22] See http://www.towerswatson.com/assets/pdf/mailings/TW-21621_July-Insider.pdf.

[23] See http://benefitcommunications.com/upload/downloads/2011MercerSurvey.pdf, p. 87.

[24] See n. 1 above.

[25] See http://www.mackinac.org/15284.

[26] See https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article/InvCommRatesAndRatios.

[27] See http://www.plansponsor.com/Report_Calls_for_10pct_to_16pct_DC_Plan_Contributions.aspx.

[28] See http://wikipension.com/index.php?title=Public_employees_and_Social_Security.

[29] See http://www.tiaa-crefinstitute.org/institute/research/articles/docs/DCPlansinPublicSectorCraneHellerandYako.pdf, p. 9, table 1.

[30] See http://www.mackinac.org/12085.

[31] See http://www.mackinac.org/17128, p. 26.

[32] See http://www.arnoldfoundation.org/foundation-debunks-myths-about-fixing-public-pensions.

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