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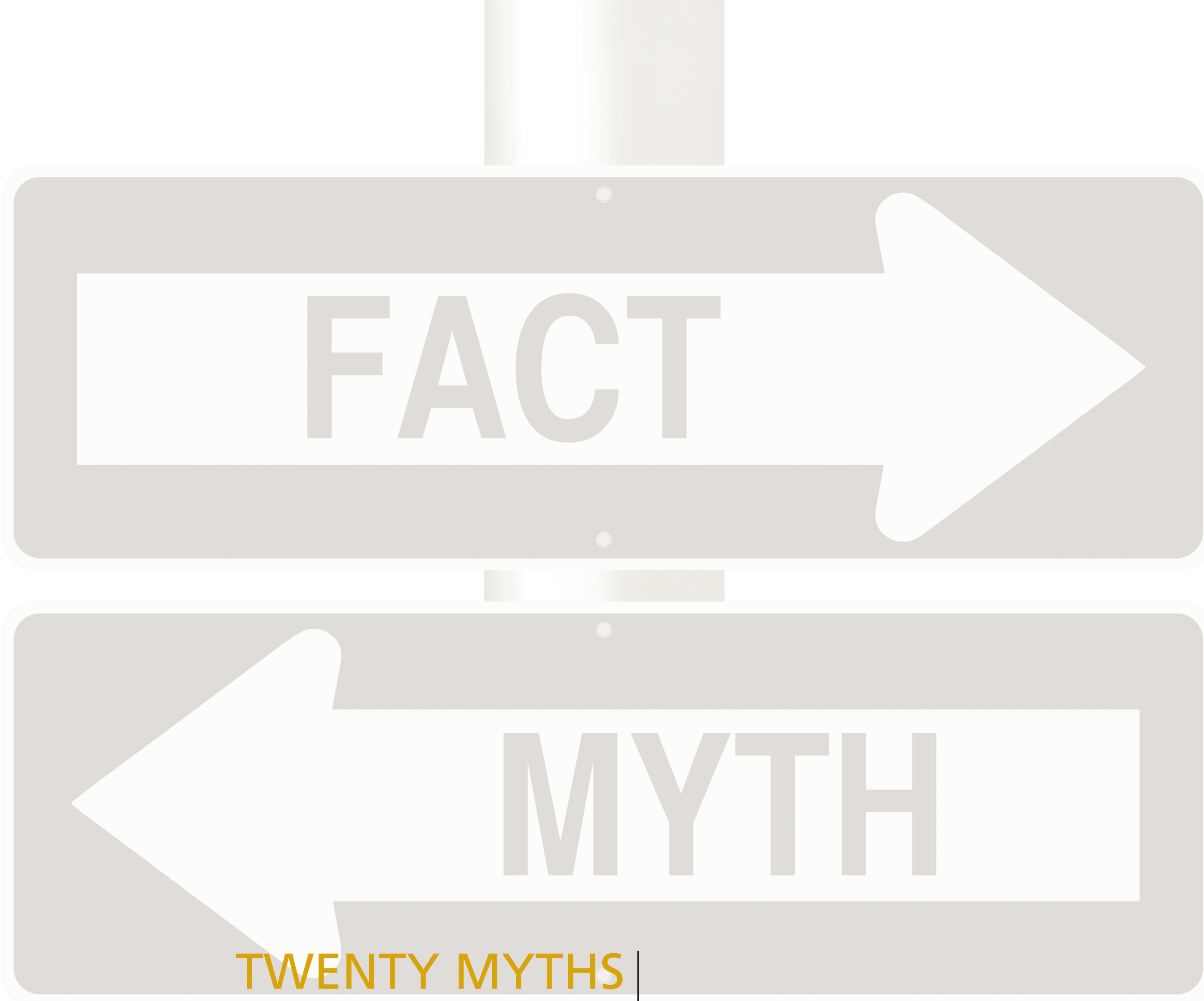

TWENTY MYTHS ABOUT PUBLIC-SECTOR PENSION PLANS

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Executive Summary

State and municipal governments across the United States know that they are facing a looming financial crisis because of their pension obligations. Politically popular yet financially reckless decisions have left many of these governments with rapidly escalating pension costs. The situation is clearly unsustainable in the long term, which is why the issue of public-sector pensions is now front-page news from California to New York to Illinois (where legislators' wages recently were suspended for their perpetual failure to resolve that state's pension crisis).

These days, everyone knows that public-sector pension reform is essential. But what kind of reform? And how is it to be achieved? There is no shortage of debate (and a number of jurisdictions claim that they have put reforms in place). Much of this discussion, though, is marred by misinformation and half-truths. These misconceptions are confusing the public discussion about pensions and facilitating the enactment of pseudo-reforms that are politically attractive but financially inadequate.

This paper identifies these nuggets of misunderstanding and inaccuracy—the myths of public-sector pensions.

After outlining the requirements for real pension reform—how states and local governments can operate pension plans that do not threaten today's taxpayers with ever-increasing contribution levels or pass the costs of today's workers on to future generations—we describe the 20 myths that make such reform more difficult. Some are myths of fact (those commonly believed assertions about pensions and pension reform that are incorrect) and some are myths of analysis (interpretations and prescriptions that are seriously flawed). They range from misinterpretations of commonly used terms (such as "actuarially sound" and "cash-balance plan") to claims about the relative merits of defined benefit plans (exaggerated) and the risks of defined contribution plans (also exaggerated).

The goal of this paper is to facilitate a fact-based and analytically sound discussion of pension reform—a discussion that cannot succeed until these widespread myths are dispelled.

About the Author

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INTRODUCTION

A key cause of the recent bankruptcy of the once-great city of Detroit was the overwhelming size of its pension obligations to its employees. Detroit is far from alone. Since 2008, a growing number of public pension plans have abandoned the standard of 100 percent funding (which rests on the bedrock assumption that benefits should be paid for as they are earned, rather than paid by future generations). As the consequences of this underfunding accumulate, more and more governments are facing considerable liquidity challenges, as higher employee pension contributions put pressure on their budgets. On current trends, the next phase of the crisis will bring more Detroits: governments will reach the end of their capacities to pay for pension contributions with financial manipulation and borrowing, and bankruptcies will be the result.

Thus pension finance has become headline news in many states. (In Illinois, for example, the governor suspended legislators' paychecks last summer, saying that they would not be paid until they successfully addressed the state's ongoing pension crisis.) It is now widely recognized that local and state governments urgently need to take steps to reform their pension systems.

But what steps? Too often, policymakers receive descriptions, analyses, proposals, and conclusions based on dubious assertions and interpretations of myriad laws, regulations, accounting requirements, and actuarial parlance. In this environment, financial manipulation and political image management can easily be branded and accepted as "pension reform." The situation is exacerbated by the incentives that politicians have to offer half-measures, where true reform would threaten their reelection chances.

The goal of any reform must be to ensure that pensions are properly funded in both the short and the long term. Yet changes toward those goals are frequently deferred, outright ignored, or predicated on overoptimistic forecasts of asset returns. States and cities must face the truth: they need to reform

both the funding and the design of pensions (therefore addressing the question of whether and what benefits can be guaranteed). Only that kind of comprehensive reform will assure long-term sustainability.

Instead, many policy debates, and even so-called pension reforms continue to be based in half-truths, exaggerations, and erroneous but commonly accepted ideas.

This paper seeks to clarify a number of these assertions—we will call them the "myths of public-sector pension plans." Some of these accepted shibboleths of the pension debate are inaccurate; many others contain varying degrees of truth but often mislead because they aren't accompanied by necessary explanations.

Reasonable people will disagree about how best to balance the needs of public-sector retirees and taxpayers, overall—but all should be able to agree on the need for an informed debate based on accurate information and sound analysis. That is the goal of this paper, in which we present 20 myths about public-sector pensions. They are divided into myths of fact (those commonly believed assertions about pensions and pension reform that are incorrect) and myths of analysis (interpretations and prescriptions that are seriously flawed). Our goal is twofold: for those jurisdictions where public-sector pension reform is under discussion, we wish to improve the terms of the debate; and for those areas where "reforms" are in place, we want to help policymakers and the public distinguish between real reforms and pseudo-reforms that fail to address the underlying issues.

BACKGROUND: THE PUBLIC-SECTOR PENSION CRISIS

The central debate regarding public-sector pension plans typically involves how to support and whether to change a "defined benefit," or DB, plan. Such plans, once common but now less so in the private sector, provide specific formula-based monthly benefit payments once a certain age or number of years of service has been reached. To make good on such a benefit, governments must make regular financial contributions to pension funds—and effectively manage those funds so that returns on investments provide income sufficient to make the expected payouts. Pressure for reform has grown because pension obligations now threaten to outstrip the government's ability to pay, since the investment risk and any resulting deficits are the responsibility of the taxpayer.

Reform proposals usually include an alternative type of pension plan known as a defined contribution, or DC, plan—in which government provides a specific level of contribution to the plan rather than a specific level of benefits. The contributed funds, which could be augmented by the individual employees, are then managed so as to provide income upon retirement. The investment risk in a DC plan is assumed by the plan member.

The importance of moving to DC plans cannot be overstated. Indeed, this paper is significantly predicated on the view that a transition to defined contribution plans is the only way to ensure the long-term financial sustainability of public-employee pension plans and, at the same time, to protect the interests of taxpayers. First, DC plans do not have unfunded liabilities —a gap between the cost of promised benefits and assets on hand to pay for them. Therefore, the employer's contribution is not at risk of increasing because of plan deficits. Second, this change also eliminates the risk of political interference in pension finance. Politics can interfere with sound pension design in two ways: when a pension plan is well funded, political pressure can improve benefits (often retroactively), adding to the cost of the plan; contrarily, when a plan is underfunded, politics can motivate officials to respond with financial manipulation. Moving to a DC plan removes these political incentives while eliminating the threat that ever-increasing contributions pose to government's fiscal health.

DC plans are thus a necessary but insufficient component of true reform. In addition to moving governments to these plans, reformers must close the door on various maneuvers that some governments have undertaken to defer their liabilities and pass pension costs on to future generations: "pension obligation bonds" and similar forms of debt financing should be prohibited.

Achieving sustainable public-sector pension systems will also require implementing new accounting standards adopted by the Government Accounting Standards Board (GASB), the independent, public-sector entity responsible for establishing financial accounting standards and reporting requirements for state and local governments. While these standards are not funding mandates, they are useful guidelines in establishing more responsible funding policies. These standards require that unfunded liabilities be amortized more quickly than in the past and that plan assets are based on market values and that unfunded pension liabilities be reported on the government's balance sheet.

Finally, true reform will likely ask more of plan participants: increased member contributions, reduced benefits, higher retirement ages, curtailment of early-retirement subsidies, reduced cost-of-living adjustments (COLAs) in benefits, and common pension provisions for all public-sector employees. Any reforms must improve the financial health of plans without increasing taxes.

All the myths that we will describe make the achievement of comprehensive and sustainable reforms more difficult.

MYTHS OF ANALYSIS

Myth #1: Many states have adopted comprehensive and sustainable pension reform.

Fact: Other than Alaska and Michigan, few, if any, states and selected local governments have established mandatory DC plans for new hires in the desired cost range of 4–7 percent of payroll, congruent with the private-sector norm.[1] Yet this is the first essential step in pension reform.

Managing the unfunded liability of the previous DB plan and preventing a transfer of cost to the next generation are the paramount challenges for any government seeking comprehensive and sustainable pension reform. This will be particularly challenging given the optimistic asset-return projections of most plans. Earlier this year, the Indiana Public Retirement System became an outlier when it lowered its annual investment return assumption from 7 percent to 6.75 percent—now the lowest of any major public pension plan.[2] Many other pension plans assume 7.5 percent returns.

Instead of facing reality, many governments have enacted what we might call "pseudo-reforms." Some, for instance, have issued "pension obligation bonds" or have used other strategies to borrow to finance their retirement benefit systems, a strategy that fails to address unrealistic benefit promises and, because it offers more resources to pension plans, poses the risk of further benefit increases. Other governments have tried to clear their employment rolls of workers on older, expensive retirement plans by offering incentives to retire early. In doing so, they enhance already generous benefits while often extending the amortization period—the number of years required to pay off obligations completely—for the unfunded liability of their plan. Others "reset" such unfunded liability, extending amortization beyond the duration of participants' remaining working careers. This is a politically expedient solution that appears to decrease pension costs, but it is contrary to proper pension funding (which holds that a pension system should be paid for entirely during the working lifetimes of its members). The reason, of course, is that this strategy passes the cost of employing today's workers on to future generations.

Other governments claim the mantle of reform after they have reduced the cost of a DB plan, introduced a voluntary DC plan, or both. But these approaches do not eliminate DB plans and therefore leave governments still financially vulnerable. The same flaw can be found in the "cash-balance" plan approach (see Myth #10).

Some plans (for example, Rhode Island's) contain provisions making annual COLAs conditional on future funding improvement. While this may be preferable to automatic COLAs, such "contingent liabilities" make it difficult for a plan to reach a 100 percent funded ratio (in which assets are equal to accrued liabilities). It is also unlikely that many plans will be able to enact funding reforms generally

consistent with the latest methodology set by Moody's or those found in statements 67 and 68 from the GASB. Such shortcomings may place governments' future credit ratings at risk, in spite of their claims to have reformed their pension plans.

Myth #2: The best measure of success in reforming a DB plan is a reduction in projected employer contribution after reform. This near-term drop represents acceptable and sustainable reform that will withstand the test of time.

Fact: Politics and DB plans are a toxic combination. Projected pension-plan contributions are simply estimates based upon future assumptions, often placing future taxpayers at significant risk. Even if one is clairvoyant in projecting future experience, the potentially significant costs relating to political forces are never quantified. Specifically, the success of any reform effort is often predicated on at least three key assumptions:

a) The achievement of annual asset returns of 7.5 percent or higher
b) No future benefits improvements (often enacted retroactively)
c) Contributing the actuarially recommended contributions (ARC)

In most cases, it is likely that none of these three assumptions will be achieved. These are examples of the political forces at work, leading to actions accounting for much of the unsustainable deficits in today's plans.

Even contributing the ARC is not necessarily a satisfactory standard, given that this term is unique to each plan's underlying assumptions, funding methods, and amortization periods. Consequently, aside from a subjective debate on the standards for "reasonable assumptions," the amortization periods often extend well beyond a period supported by the plan's own demographics. Most ARCs are also likely to be significantly lower than the separately computed annual pension expense used for accounting and financial-reporting purposes. Such standards were recently revised in the GASB statements 67 and 68.

Myth #3: Uniformed public-sector employees require a defined-benefit plan.

Fact: This myth is a major reason that many pension-reform efforts involving DC plans have failed to include uniformed services. It is often cited to give policymakers a false choice: a DB plan or public safety.

The claim is sometimes stated in moral terms—those who risk their lives for the community should be well protected in the event that their work leads to death or life-altering injury. In other instances, it is made as an argument for practicality: without the assurance of a generous DB plan, government will find it difficult to recruit qualified people for uniformed jobs. Neither assertion is universally correct.

Certainly, those who risk their lives for the community should be afforded significant death and disability benefits. In fact, most states have adopted statutes specifically addressing such contingencies. Retirement benefits for uniformed employees should be similar to those of non-uniformed employees. In the event that such a practice would preclude the hiring of necessary and qualified individuals, any adjustments should be made through base pay.

DB plan advocates also note that some public safety employees do not participate in Social Security. This can be remedied in DC plans by offering higher employee-plus-employer contributions of 18–20 percent, according to a TIAA-CREF study.[3]

The case for DB pensions here, then, is not strong. On the other hand, the argument against such benefits for uniformed workers is convincing. It rests on the fact that DB plans provide full benefits on retirement after a set number of years of service, regardless of health or age. As a consequence, in many states and localities, a healthy uniformed employee can leave the workforce and receive full retirement benefits as early as age 50. This deprives the workforce of much knowledge and expertise and results in extra costs.

In Pennsylvania, for example, the need to replace a significant number of retiring state police, most of

whom can retire at age 50, forced the state to create three new classes of recruits.[4]

These generous retirement provisions often conflict with the employees' own preference to remain employed. This has given rise to the creation of costly Deferred Retirement Option Plans (DROPs). These plans effectively allow participants qualifying for retirement benefits payouts to remain actively employed for up to five years while their pension benefits accumulate separately within the plan—as if they had retired on the earlier date. At their deferred retirement date, this accumulation (often with interest added) is paid as a lump sum, in addition to the ongoing normal monthly pension. In a sense, this approach creates a bidding war, pitting an incentive to retire against an incentive to stay on the job. Perversely, both competitors are the government that employs the worker. In other words, this is effectively a bidding war in which government is bidding against itself.

A far less costly solution would be to address early retirement, which removes experienced and knowledgeable people from public service, with more effective human resources polices. This means that employees in the latter part of their careers should be afforded opportunities in staff positions or related career training to capitalize on their acquired knowledge and expertise rather than promised extra payments that most local and state governments can ill afford.

Myth #4: A particular pension plan remains in satisfactory condition based upon the fact that no retiree has yet to be denied a payment.

Fact: Plans are going through three stages of financial distress.

Stage 1: Plans abandon 100 percent funding targets, legalize financial manipulation and underfunding—generally occurring since 2008.

Stage 2: Systemic liquidity challenges; projected higher pension contributions creating budgetary pressures and/or tax increases.

Stage 3: Prefunding is fully compromised; widespread borrowings and more bankruptcies. This will occur over the next five to 15 years.

Myth #5: The GASB sets requirements on how plans should be funded.

Fact: In 2006, GASB statement 25 ("Financial Reporting for Defined Benefit Pension Plans") established 30 years as the maximum amortization period for unfunded liabilities in determining the ARC. This replaced the previous standard of 40 years. However, this accounting standard is not a governmental funding requirement unless adopted as a funding statute or formal funding policy. Frequently, states have contributed less than this accounting standard, which explains much of today's unsustainable unfunded liabilities. Predictably, some DB advocates have argued that these GASB changes are unnecessary and confusing to the public.

In fact, these new standards are consistent with the principle that benefits should be funded as they are earned, with deficits amortized over durations supported by the demographics of the plan, meaning the average remaining years of active members' employment until their expected retirement date.[5] These standards establish that unfunded liabilities will now appear on the balance sheet of sponsoring employers.

Overall, these new standards are a thoughtful and well-timed update. They will require more appropriate recognition of pension costs and should positively influence the need to better fund these pension systems using the market value of assets. The standards will also create pressure on systems to more seriously consider reforms in the interest of keeping plans current and affordable.

It is significant that Moody's, which analyzes credit risk, has updated its measurement standards supporting reduced amortization periods as well.

Myth #6: The unfunded actuarial liability (UAL) is not important, since it assumes that everyone will be retiring today.

Fact: Under most actuarial cost methods, the UAL is a snapshot of the present value of benefits earned to date, less assets available to pay these same benefits.

Some earned benefits are currently in pay status, and other benefits are payable at a later date. Therefore, the UAL does not represent the value of all participants retiring today.

In theory, if a plan were sold to a third party to assume its obligations, the unfunded liability would represent a deficit that would need to be satisfied. Any reasonable observer would find this deficit to be more than that estimated by the plan because plans customarily assume an optimistic annual return rate of 7.5 percent on assets.

Myth #7: New members are needed to sustain DB plans. Without them, plans will incur transition costs that make DB-to-DC conversions unaffordable.

Fact: Pension systems are designed to be self-sustaining. DB plans, if properly designed and administered, should not need new members to sustain themselves. The claim that a plan needs new members to sustain itself, then, is a red flag indicating that basic funding principles have been compromised. Such a contention supports the caricature that pension systems are effectively legalized Ponzi schemes.

In a closed DB plan, it is reasonable to assume that investment returns will eventually decline with an aging workforce and a corresponding declining time horizon. This impact is commonly referred to as a "transition cost."

Nonetheless, the argument is sometimes advanced that DB plans are so unsustainable without new members that governments cannot afford to close their DB plans and move to a DC system. Some pension plans, concerned by this prospect, retain their DB system, even as they offer a DC option. Worse, when these plans calculate the percentage of payroll that the DB plan costs, they sometimes use their total payroll—including the wages of DC plan participants. This makes their accounting process less onerous but hides the real cost of the DB plan. This is a poor funding practice, since it first "mal-assigns" costs and provides no assurance of any date-certain payoff. It is on the road to perpetual amortization.

Most illustrations quantify transition costs by comparing projected employer contributions of the closed plan with those of the current system over a 30-year duration. To properly analyze these costs, the results should be computed on a present-value basis that adjusts for the time value of money. Often, such illustrations presume that the current scenario of 7.5 percent asset returns is a certainty—when, in fact, that presumption is highly debatable.

One recent illustration involved a 30-year projection of closing the Pennsylvania School Employees Retirement System (PSERS) in favor of a DC plan for new hires. The nominal increase in employer contributions was stated at over $39 billion. However, the author computed the net present value of this change to be just over $6 billion. While such a number is still significant, it needs to be placed in perspective. Over the past four years, PSERS reduced its annual return-rate estimate from 8.5 percent to 7.5 percent. This alone added an estimated $8 billion to its UAL. Yet this change occurred without any fanfare or hyperbole. Therefore, transition costs that are lower than this figure should not preclude serious consideration of a DC plan.

Of course, this modeling assumes that projected employer contributions will be made as scheduled, that the 7.5 percent return will be achieved, and that no new benefits improvements will occur. It is unlikely that all these assumptions will prove true. On the other hand, if there were no political pressure to estimate high returns, or to change contributions, or to add benefits, there would be no need for such assumptions and therefore no risk. In other words, there are significant future savings in removing politics from public pension-plan management. When the costs of transition from DB to DC is discussed, though, these gains are seldom mentioned, much less quantified.

Myth #8: The federal government needs to play a role in state pension-reform efforts.

Fact: Government induces moral hazard when it attempts to manage risk. This unfortunate effect of protecting people from the consequences of their actions applies to federal loan guarantees, Medicare,

Medicaid, Social Security, and the Affordable Care Act, among other instances.

Within the domain of private-sector DB pensions, we see the inducement of moral hazard in the actions of the Pension Benefit Guaranty Corporation (PBGC). This entity was established under the Employee Retirement Income Security Act of 1974 (ERISA) to ensure certain levels of pensions while requiring participating plan sponsors to pay premiums. PBGC currently has an estimated deficit of more than $29 billion.[6] The prospect of higher premiums on participating employers, together with the myriad federal regulations affecting DB plans, creates powerful disincentives to discontinue these arrangements.

The concept of requiring private-sector pension plans to have insurance as part of ERISA was sound; not using the private-sector insurance market where risk can be properly managed was the flaw.

In addition to the risk of moral hazard, this myth runs counter to the American tradition of federalism, in which the preferred venue for problem-solving policies is local governments, which are closer to the citizenry and reflective of its diversity of political and economic ideas.

MYTHS OF FACT

Myth #9: Since government entities are perpetual, pension obligations can be deferred indefinitely.

Fact: This is the de-facto funding policy in many state plans because they annually reset their amortization periods. Such a practice is referred to as "open amortization" because this method sets no certain endpoint to payments into the plan.[7] Though this myth is usually tacitly assumed, it is sometimes stated explicitly. For example, a 2004 Pennsylvania state government report actually made such a claim.[8]

As a further example, recent actuarial reports from Montana's two major pension systems[9] reflect a funding policy that "does not amortize" at all. This means that the current contribution schedule is insufficient to ever fully pay off the plan's unfunded liability.

The proper funding standard is to contribute sufficient amounts to provide for accumulations such that the plans are effectively paid up in the aggregate at retirement. For instance, a plan whose participants have an average age of 45—and an assumed average retirement at 60—should establish a funding goal to pay off its unfunded liabilities over a period of not longer than 15 years (to use the technical term, it should have a "closed amortization period" of 15 years). Recent GASB changes have redefined annual pension expense to align better with this standard. This will result in the annual accounting expense significantly exceeding the actual amounts contributed in most states.

Those who favor DB pension plans sometimes invoke the concept of "intergenerational equity" to justify the perpetual passing on of pension costs. This term refers to the claim that the burden of unsustainable liabilities should be equitably shared among generations. For anyone who does not share this philosophy, of course, "intergenerational equity" is simply a term for saddling future generations with the burden of paying for the promises of their predecessors. "We shall all consider ourselves unauthorized to saddle posterity with our debts, and morally bound to pay them ourselves," Thomas Jefferson wrote.[10] For many, these words are just as true and just as urgent today as they were when they were written in 1813.

Myth #10: Cash-balance plans offer a route to meaningful reform.

Fact: This myth is predicated on the notion that in addition to DB and DC plans, there exists a third category of pension plans, called "cash balance."

In reality, there is no third category of public-sector pension plan. Cash-balance plans are simply a specific type of DB plan. The Internal Revenue Service and the Department of Labor regulations explicitly define DC plans.[11] Any plan that does not meet this definition is a DB plan. The Department of Labor's website makes this clear:

> There are two general types of pension plans—defined benefit plans and defined contribution

> plans. In general, defined benefit plans provide a specific benefit at retirement for each eligible employee, while defined contribution plans specify the amount of contributions to be made by the employer toward an employee's retirement account. In a defined contribution plan, the actual amount of retirement benefits provided to an employee depends on the amount of the contributions as well as the gains or losses of the account.
>
> A cash balance plan is a defined-benefit plan that defines the benefit in terms that are more characteristic of a defined-contribution plan. In other words, a cash balance plan defines the promised benefit in terms of a stated account balance.

Further obscuring matters, some have chosen to describe cash-balance plans as "hybrid" or "combination" plans. The term "hybrid" can also refer to separate stand-alone DB and DC plans offered within an employee-benefits program.

The cash-balance plan is effectively a career-average DB plan, where the accrued benefit is expressed as an account balance that grows with "interest" and "pay-based credits." This provides the appearance of a DC plan, as hypothetical accounts are created that are simply liabilities from the plan itself. Depending upon the specific design features, the accrued benefit can also be affected by actual DB asset returns. Frequently, at retirement, all or part of the accrued benefit is required to be taken as an annuity.

Conceptually, cash-balance plans are neither good nor bad. Practically, however, given that they are DB plans, they are subject to the same political pressures as any other form of DB public-sector pension plan: accounts can be retroactively increased; the plans can be underfunded; and their assets are valued with an assumed rate of return that may, for political reasons, be set too high. Most important, as with any DB plan, a cash-balance plan can generate unfunded liabilities. Only DC plans take politics out of pension arrangements.

Not surprisingly, as the popularity of DB plans has faded in the private sector, so, too, have cash-balance plans.[12] Major benchmark employers no longer offer such plans as part of an overall trend away from DB plans. IBM discontinued its cash-balance plan in 2005.[13] Some might consider it surprising, then, that in the public sector eight years later, cash-balance plans are considered viable reforms. (Others, more cynically, might deem this not at all surprising.)

Myth #11: The annual normal cost of a DB plan can readily be compared with the annual employer contribution of a DC plan.

Fact: The normal cost[14] of a DB plan is the present value of benefits earned in the current year. The normal cost is a function of the actuarial assumptions. The accuracy of any particular normal cost can be validated only by future plan experience.

In contrast, the annual DC employer cost is an actual and final cost. If annual cost comparisons between DB and DC plans are considered necessary, these calculations should be made under various scenarios to illustrate the sensitivity inherent in the DB normal cost.

Myth #12: "Actuarial soundness" is a well-defined and commonly understood term.

Fact: This claim is often invoked to preempt probing questions regarding a particular plan design or funding approach. "Actuarial soundness," though, has no rigorous definition. It is a qualitative term referring to whether a debt is ultimately satisfied—not a quantitative term identifying a specific duration with related details.

This issue has proved to be so amorphous that the American Academy of Actuaries (AAA) found it necessary to commission a study in 2012 to clarify matters. That report warned: "At the legislative level, many states also mention actuarial soundness in the context of the funding of their pension plans. In many of these cases, the references presume that the concept is widely understood and generally accepted, without further elaboration. In some cases (such as California), the legislature puts the onus on the independent actuary to certify the actuarial soundness of the funding requirement."[15]

Myth #13: An "80 percent funded" status is the sign of a healthy pension plan.

Fact: A plan's funded ratio is simply the ratio of its assets to its accrued liabilities. The bedrock standard here is that benefits should be funded as they are earned. In such a situation, the ratio of assets to liabilities is 100 percent. Only a 100 percent funded ratio marks a plan that is current in its funding progress toward its ultimate long-term goal.

Yet many stakeholders have come to believe that a funded ratio of 80 percent or more is the sign of a healthy plan. This widely believed myth is a tribute to the persistence of DB plan advocates, who have succeeded in "moving the goal posts" from 100 percent to 80. But the claim that a plan can be healthy or actuarially sound at 80 percent is the precise equivalent of the claim that a family is in good financial shape when it is "only" 20 percent behind in its mortgage payments.

The AAA has weighed in on this issue in a 2012 report: "The 80% Pension Funding Standard Myth."[16] It argues that, in the words of Donald Fuerst, senior fellow with the AAA: "The 80% myth can lead to a dangerous slippery slope. It could evolve into an inadequate target if not challenged. Pension plans should have a strategy in place to attain or maintain a funded status of 100 percent or greater over a reasonable period of time."

Myth #14: All funded ratios are comparable.

Fact: Pension policy choices are often debated in terms of plans' funded ratios, with the assumption (sometimes explicit, sometimes implied) that different plans' ratios are derived by the same methods and types of data and are therefore easily compared. But the numbers that make up a funded ratio—assets divided by liabilities—are determined in different ways by different pension systems. Indeed, plans are free to make decisions that affect both the numerator (assets) and the denominator (liabilities) in a ratio. There is no required standard.

Without a standard for evaluating the relationship of assets to liability, plans are free to claim funded ratios that are more favorable than reality warrants. Most plans' funded ratios are actually more unfavorable than disclosed because of their tendency to overvalue their assets and to assume an optimistic 7.5 percent per annum return on those assets.

Myth #15: Public-sector employer pension costs are properly reflected in official reports detailing total compensation in studies such as that of the Bureau of Labor Statistics (BLS).[17]

Fact: Table 3 of the March 2013 BLS report indicated the following for state and local government employees:

Item	Average Employer Cost per Hour	Expressed as a Percentage of Wages and Salaries
Defined Benefit Pension Cost	$ 3.45	12.65%
Defined Contribution Pension Cost	$ 0.33	1.21%
Total Retirement and Savings Cost	$ 3.78	13.86%
Wages and Salaries	$27.27	

It is noteworthy that average DB pension costs are reported as 12.65 percent of payroll. This figure is presumably representative of employer contributions actually made to the respective pension systems. The trouble, of course, is that pension plans are chronically underfunded. Therefore a result of 12.65 percent significantly understates pension costs and could provide misleading conclusions if used in formal analyses and comparisons.

With mounting unfunded liabilities, these contribution numbers will only increase. Such figures should be restated or footnoted based upon what should be contributed as determined by the latest accounting standards. (For instance, as a proxy, the GASB annual expense figures could be used as well.) However they are estimated, though, the adequacy of annual DB contributions can be determined only in hindsight, when a plan's past performance is measured. Such

issues do not exist in DC plans where actual annual contributions reflect the actual and final costs. A similar analysis should take place regarding retiree health-care costs.

Myth #16: Approximately 70 percent of DB fund growth comes from investment earnings, so there is no need to worry about increases in employer contributions.

Fact: This assertion has been offered to mollify the citizenry into readily accepting annual increases in the employer contribution rate in a DB plan, despite the possible consequences for tax rates or government services. What this claim fails to clarify is that DC plans also reap 70 percent of their fund growth from investment earnings. But DC plans, of course, cannot pose the threat of ever-rising employer contributions to address mounting unfunded liabilities.

Myth #17: The state of Michigan incurred significant transition costs with dramatic increases in the unfunded liabilities as a result of closing its DB plan, the Michigan State Employees Retirement System (MSERS), in 1997.

Fact: Another oft-mentioned argument for doing nothing about unsustainable DB plans, this claim is wielded to claim that a switch from DB to DC public pensions will be too costly to pay off. The author estimates a savings of $2.2 billion to $4.2 billion to Michigan taxpayers associated with this 1997 change.[18] Nonetheless, the myth persists that the transition costs are significant and have damaged a once-sound pension plan.

It is true that in 1997, MSERS had no unfunded liability when this plan was closed to new members. But it was a combination of underfunding and poor investment performance, which did not live up to the plan's assumption of an 8 percent annual return, that created its unfunded liability in later years. These developments, not the closing of the DB plan, were the source of the plan's later troubles.

Based upon the most recent valuation reports, the Michigan Public School Employees Retirement System (MPSERS) plan, which has remained open to new members, and MSERS have a nearly identical current funded ratio of approximately 60 percent (using the market value of assets). Both plans continue to use an 8 percent return assumption with amortization periods extended out over 24 years.

MPSERS and MSERS are quite similar and are in similar difficulties. Yet only one closed its DB plan. That closure, then, is not a very likely explanation for MSERS's current situation.

Myth #18: The average annual public-employee pension is $25,000.

Fact: This myth is another piece of information offered without context or explanation, usually to defend the idea that DB pensions are not an unreasonable burden on governments. Statistics such as this are drawn from a wide range of ages, stretching from early retirees in their fifties to surviving spouses in their nineties. Such averages can be, to say the least, misleading.

For an illustration, consider the Pennsylvania Public School Employees Retirement System (PSERS), which permits retiring employees to withdraw their accumulated employee contributions in exchange for a lower monthly annuity (a provision that was eliminated for new hires beginning in 2010). Based upon the most recent actuarial valuation, the average pension overall is $25,323. However, the average pension for a full-career individual retiring between the ages of 60 to 64 with 30 to 34 years of service is $45,349.

A more meaningful analysis would consider the percentage of income replaced at retirement, including Social Security.

Myth #19: DC plans have higher administrative costs than DB plans, and DB plans can provide the same level of income at nearly half the cost of a DC plan.

Fact: In today's competitive environment, DC plans now offer well-diversified low-cost plans, making this assertion dubious, at best. (For details, a 2011 Deloitte and ICI study reports the declining trends in DC plan administration costs and is a useful

benchmark study.)[19] In fact, one can find examples of efficient and non-efficient plans in both the DB and DC realms. Differences in administrative costs are not dependent on the type of plan involved; usually, they reflect the presence (or absence) of economies of scale. DC participants can now take advantage of market changes by participating in established competitively priced pooled funds from well-established firms. A high-cost plan, be it DB or DC, should prompt a market search for a better deal.

Opponents of DC plans have another way of claiming that governments would pay more for a DC plan than they would for a DB plan: the claim that DB plans have higher returns on their assets. This assertion is predicated upon two facts.

First, DB plans' investment returns historically have outperformed DC plans by an average of 0.76 percent per year, according to a recent Towers Watson study.[20] However, in today's world of automatic enrollment, target-date funds, optional annuity payouts, and very competitive expense ratios, any such differentials in the future should be minimal.[21]

Second, within a DB plan's group annuity pool, shorter-lived individuals effectively subsidize longer-living members. Every premature death in the pool frees up resources that will help support a surviving annuitant. However, in a DC plan, every participant's remaining account balance at death goes to a designated beneficiary.

The missing context in this claim, of course, is the overall condition of a pension plan. DB plans expose taxpayers to the risk of ever-increasing contributions by government required to sustain the plan. DC plans do not. Governments now contending with rising contribution requirements have not realized—and will likely not realize—any "savings" from their DB plans.

Myth #20: A pension plan with a 30-year amortization should be as readily accepted as a 30-year homeowner's mortgage.

Fact: If the actuarial assumptions are entirely met, employee and employer contributions are made as scheduled, and no unplanned benefit changes occurred, then, in theory, a pension plan should never have an unfunded liability. In reality, this scenario seldom occurs, and most plans incur unfunded liabilities (or, more rarely, surpluses).

How should deviations from the ideal be managed? In the case of unfunded liabilities, the answer is to amortize the amount. The duration of the amortization should be determined by the underlying demographics of the plan—taxpayers should be paying for the retirement of their current employees and should not be passing the burden of those payments on to future taxpayers. Therefore, amortization should not extend beyond the average remaining working careers of employees who will benefit from the plan. Such an approach is the basis of standard actuarial funding approaches. The GASB and bond-rating agencies such as Moody's view this standard as appropriate as well.

Comparisons between pension plan and homeowner amortization periods are a sign that politics, rather than financially sound practice, is at work. The reason is simple: while 30 years may sound comfortably familiar to mortgage-holding voters, it is a term that may be inappropriate, given the demographics of the workers covered by a pension plan.

CONCLUSION

Public-sector pensions, as a *Wall Street Journal* editorial observed some years ago, are inherently political institutions. They have been designed, managed, and evaluated according to political criteria, for political purposes, to the detriment of their financial sustainability—and therefore to the detriment of the governments that are responsible for them. This political approach to financial issues has helped foster the myths that we have described in this paper—claims that rosy assumptions are facts; claims about the meaning of commonly understood terms that are not correct; and analyses of proposed reforms that circulate because DB advocates promote them, not because they are accurate.

The public-sector pension systems that have sustained these myths—and that have been sustained

by them—cannot be maintained indefinitely. Already, those systems threaten the fiscal health of state and local governments across the country. Real reform—which would eliminate unfunded liabilities, remove politics from pensions, and eliminate taxpayer obligations that extend in perpetuity—is long overdue. But it cannot be implemented until policymakers see past the half-truths and untruths about public-sector pension plans. True pension reform must be based on facts, not myths.

ENDNOTES

[1] See http://www.manhattan-institute.org/html/cr_74.htm#.UiD2az_3NyE.

[2] See http://in.gov/inprs/2715.htm.

[3] See http://www1.tiaa-cref.org/ucm/groups/content/@ap_ucm_p_tcp_docs/documents/document/tiaa02029480.pdf , p. 9, table 1.

[4] See http://www.prnewswire.com/news-releases/pa-governor-corbett-announces-funding-for-three-new-state-police-classes-188881051.html.

[5] Different durations apply to asset losses and plan amendments.

[6] See http://www.prnewswire.com/news-releases/pbgc-deficit-estimate-stands-on-firm-actuarial-ground-220715471.html.

[7] In contrast, a "closed amortization" contains a certain date where the liability is reduced to zero.

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

[9] 2012 Actuarial Valuations for Public Employees' Retirement System of the State of Montana and Teachers' Retirement System, State of Montana.

[10] See http://yamaguchy.com/library/jefferson/eppes1.html.

[11] See http://www.dol.gov/ebsa/faqs/faq_consumer_cashbalanceplans.html.

[12] See http://www.towerswatson.com/en-US/Insights/Newsletters/Americas/insider/2012/retirement-plan-type-of-fortune-100-companies-in-2012.

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

[14] In reality, the normal cost is uniquely defined according to the particular actuarial cost method. For the purpose of this discussion, it is assumed that the entry-age cost method is used. This is the most common actuarial cost method used in the public sector.

[15] See http://www.actuary.org/files/Actuarial_Soundness_Special_Report_5.10.12.pdf.

[16] See http://www.prnewswire.com/news-releases/actuaries-debunk-myth-that-80-pension-funded-ratio-alone-constitutes-actuarially-sound-164580776.html.

[17] See http://www.bls.gov/news.release/pdf/ecec.pdf.

[18] See http://www.mackinac.org/archives/2011/2011-03PensionFINALweb.pdf.

[19] See http://www.iciglobal.org/pressroom/news/11_news_deloitte_401k.

[20] See http://www.towerswatson.com/en/Insights/Newsletters/Americas/insider/2013/DB-Versus-DC-Investment-Returns-the-2009-2011-Update.

[21] Quoting from the Towers Watson report: "Standard deviation is a measure of how closely observations cluster around the mean in a data set. With the exception of 2002 and 2003, DC plans had a wider distribution of investment returns before 2008. But from 2008 to 2011, standard deviations were higher for DB plans. A possible explanation is that DB plan sponsors are shifting to more varied asset allocations in an attempt to right-size risk in their investment portfolios, which is leading to a wider distribution of performance across plans (including those that have not changed their investment strategies recently). The implementation of the Pension Protection Act prompted many DC plan sponsors to install target date funds as the default investment arrangement for workers, which might be causing less dispersion in DC returns."

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