



PENSIONS Under Pressure

Government workers have long looked forward to retiring with generous, taxpayer-guaranteed nest eggs. But many of those retirement systems are having trouble staying in the black

BY DOUG CAMPBELL

West Virginia is famous for its spectacular mountains, ample mineral deposits, and its spirit of independence. But the Mountain State is known for all the wrong reasons when it comes to its public pension system. West Virginia is home to the nation's worst-funded major retirement plan for state and local government employees. Specifically, its main fund for teachers faces an estimated shortfall of almost \$5 billion, holding only 25 percent of the financial assets deemed necessary to pay for the promised retirement packages of about 46,000 workers.

How did this happen? While many economic factors could contribute to the situation, at its heart pension management suffers from a fundamental mismatch between authority and accountability. Administrators of public pension plans make decisions for which their accountability could be limited, because the consequences of their decisions happen so far in the future. Economists argue that this problem is a form of "moral hazard."

Dan Foster, who is the current chairman of the West Virginia Senate's Pensions Committee, has a succinct explanation for what happened with the teachers' plan: "We did not fund it as we should have. And at the same time, the benefits that were given to state retirees and teachers for this program were continuing to increase for political reasons. We are dealing

with election cycles which tend to be a lot shorter than these financial cycles, so legislatures tended not to worry about what would happen 10 or 20 years in the future."

To crawl out of this hole, West Virginia in 2000 tried to float a \$3.9 billion obligation bond, only to have it blocked because a court said it needed voter approval. A \$5.5 billion bond got on the ballot last summer but failed. Now, the state is relying on a 40-year plan, begun in 1994, to slowly close the gap with regular payments. Meanwhile, the teachers' fund was closed to new hires for several years, though it has since been reopened.

While pension administrators — both public and private — generally may face the temptation to inadequately fund future obligations, not all plans are in trouble. For example, North Carolina suffers no such pension woes. Its system, which encompasses almost 600,000 workers and retirees, has a \$3.4 billion surplus. When watchdog groups express concern about public pensions, they never bring up North Carolina.

Just the same, public pension critics have plenty of ammunition. From West Virginia to Illinois, many governments are struggling to shore up their public pension systems. Granted, some of these cases may not be primarily due to accountability problems. Since funding of public pensions is largely dependent on private sector employment — and

the taxes they generate — it's possible that actuarial assumptions could be thrown off in states where growth in public-sector employment has outflanked the private sector. But in the case of West Virginia, at least, that doesn't appear to be the main problem.

A lot of the debate over what to do — if anything — about public pensions centers on whether to shift responsibility for retirement saving from governments to employees. Like the debate over Social Security, this one turns on public opinion about the merits of an "ownership society" versus the seeming safety associated with state provision of benefits. Beyond the political debate, though, lies a straightforward economic observation: Despite some recent reforms, policymakers face a powerful temptation to borrow from, or put off contributions to, public pensions to cover spending on other projects.

From Perk to Problem

Not so long ago, retirement in the United States was nothing more than the last few, declining years of life, usually spent dependent on children. In 1880, almost eight in 10 men over the age of 65 still worked; by 2000, the rate had fallen to less than two in 10. Now, retirement is "an extended period of self-financed independence and leisure," as economic historian Joanna Short puts it. There are many factors contributing to this trend, including

increased personal incomes and affordability of leisure pursuits, plus advances in health care that help people enjoy more active old ages. But also playing a central role was the development of Social Security and pension programs. Increased wealth made possible all the other factors creating longer retirements.

The first public pension in the United States was set up in 1781 for military members. The first pension plan for state or local government workers was established by New York City for police officers in 1878. Eventually, these plans became the norm, encompassing teachers, firefighters, sanitation workers, subway drivers, court clerks, and sheriffs' deputies, among others.

Today, the United States is home to about 2,600 public-sector pension plans covering some 20 million active and retired state and local government employees. In all, these plans are obligated to pay an estimated \$2.4 trillion (in present value dollars) to their beneficiaries. About 90 percent of state and government employees are covered by "defined benefit" plans, compared with less than 25 percent in the private sector. In general, the private sector has been moving away from defined benefit plans.

Basically, a defined benefit plan provides an annuity at retirement that people can't outlive: Work a certain number of years, and then collect a percentage of your salary until you die. Its assets are professionally managed and the employer bears most or all of the investment risk.

There are subtle deviations from this central premise. Benefits in such plans usually are calculated according to a formula based on years of service and percentage of pay. Sometimes employees are required to contribute to their employers' pension plan, sometimes not. Sometimes employees also are opted into the Social Security system and their paychecks taxed accordingly, sometimes not. But overall, it's a great deal for employees. A possible exception, of course, are employees of private companies that

later encounter financial trouble and renege on their pension promises.

The backlash against public pensions really began to pick up steam just five years ago. When the stock market was roaring in the late 1990s, many governments pared back their pension contributions, using the unexpected gains on their investments to cover the difference. (Most pension systems invest assets in a variety of securities, ranging from stocks to government bonds.) But then came the market retreat of 2000 and 2001, and pension plans that had looked in good shape suddenly needed help, their rosy 8 percent investment return estimates way off. "We experienced a bit of a perfect storm in terms of the confluence of events," says Keith Brainard, research director with the National Association of State Retirement Administrators (NASRA).

These squeezes sometimes force governments to cut back on services. A school district in Michigan, for example, had eliminated teachers and halted new textbook purchases as it tried to meet its pension obligations, according to a *BusinessWeek* cover story last summer.

Funding Crisis?

At present, state and local government pensions have on average enough to pay between 84 percent to 88 percent of what they owe, depending on which survey you look at. According to actuarial standards, anything above 80 percent is considered sufficiently funded. Almost one in three plans falls below the 80 percent threshold. Nationwide, only two states (North Carolina and Florida) have total pension system assets greater than liabilities. (See chart for conditions of Fifth District public pensions.)

In one of the nation's most comprehensive annual surveys, the Wisconsin Legislative Council looked at 85 pension plans in all 50 states, or about three-quarters of all public-sector employees covered by pension plans. The survey found that the number of plans with funding ratios topping 100 percent fell from 33 to nine between

2000 and 2004. The same study found a general trend toward improving benefits, such as allowing earlier retirements and increasing multiplier formulas for determining benefits. These actions yield long-term effects; by law, once employees are awarded benefit levels, those levels cannot be reduced. Only new employees are affected when lawmakers move to reduce benefit levels.

To some analysts, these statistics provide ample evidence that pensions are particularly vulnerable to poor management. The reason that many pensions are dangerously underfunded, the reasoning goes, isn't because of unexpected drops in the stock market. It's that pension managers and politicians had no incentive to ever consider the possibility that investment returns would falter. Even defenders of public pensions acknowledge this inherent disconnect. "They made a lot of promises during those (bull market) periods thinking that the high equity values and the high discount rates would enable them to pay off those promises without too much pain," says Douglas Elliot, president of the Center on Federal Financial Institutions, a non-profit policy institute in Washington, D.C., that monitors federal government lending and insurance activities. "It looks a lot more painful now."

The Reason Foundation, a think tank based in Los Angeles, published a paper in 2005 titled "The Gathering Pension Storm: How Government Pension Plans Are Breaking the Bank," which cited myriad ways public pensions have been exploited. "Pension spiking" refers to the practice of employees who manipulate the system to make their compensation as high as possible just before retirement, the result being that their pension benefits — which are tied to their final compensation — also rise. Then there are the so-called "Drop" plans, in which senior employees amass a special fund filled with proceeds they would have gained if they had retired, and then get to cash it out upon their real retirement. Sometimes senior employees face incentives to take advantage of

these plans whether they are considering retiring or not.

“There are strong political incentives to increase benefits and push off obligations into the future,” says Adam Summers, a Reason Foundation policy analyst. The most oft-proposed remedy is a wholesale shift from defined benefit to defined contribution plans. This is already happening in the private sector, where the number of defined benefit plans has fallen 70 percent since 1985 while defined contribution plans have grown by almost 50 percent.

A defined contribution plan has become more broadly known as a 401(k). Such plans don’t guarantee benefits but rely on regular contributions from both employees and employers to build tax-deferred nest eggs that are usually dispersed in lump sums upon retirement. All the risk resides on the shoulders of employees, which in the case of public pensions means that governments — and by extension, taxpayers — are off the hook. On the flip side, all the control over investments goes to employees. This can be a positive in the sense that you would expect defined contribution members to take more care in planning for their financial futures because of their strong incentives to do so.

Summers disputes the notion that governments need defined benefit plans as a recruiting tool for the best

employees. Private-sector workers make an average \$16.71 an hour; their public-sector counterparts earn \$23.52. It’s true that there is a higher percentage of white-collar professionals in the public sector, in particular teachers, which raises the average among government workers. But even among comparable professional positions, government workers still make a hair more than private-sector workers.

Moreover, the recruiting virtues of defined benefit plans are uncertain. While it’s true that government workers with 20 years or more of service are grateful to have their retirements virtually all paid for, a defined benefit plan might not be so useful a recruiting tool for young workers. To a 20-something professional, who is likely to switch jobs several times in his career, a portable, defined contribution plan makes a lot more sense. Some public systems offer both defined benefit and defined contribution plans.

In a recent paper, the National Association of State Retirement Administrators responded, saying the Reason study was “based on a distorted picture of the public pension funding situation.” While acknowledging that administrators face incentives which could lead them to underfund future obligations, NASRA’s Brainard argued that legislation can cure most public pension ills. He pointed to Georgia as an example of a state that has passed

strict standards aimed at ensuring that public pensions remain solvent. In principle, Brainard accepts the argument that there is a disconnect between who authorizes funding for public pensions and who ultimately is accountable for making sure the money is there when needed. “The ‘moral hazard’ argument is definitely valid,” Brainard says. “But to me, it’s less to do with the inherent nature of a defined benefit plan and more to do with the way it’s established and implemented.”

Success in North Carolina

North Carolina is as good an example as any of a state where defined benefit plans haven’t wreaked fiscal havoc. “When people talk about defined benefit plans, if any one of the pieces of the puzzle is missing, it can be a recipe for disaster,” says Richard Moore, the state’s treasurer. “We are as a state reaping the benefits of having a properly endowed and mature pension fund.”

North Carolina, unlike a lot of other state pension plans, requires employees to contribute — the state takes 6 percent out of every paycheck before making its contribution. Granted, the state’s contributions can change year by year. For example, North Carolina was putting less than 4 percent of payroll and as little as zero during the bull run of the late 1990s,

Pension Plight

West Virginia’s pension plan for teachers has the worst funding ratio among major public-sector plans in the nation; North Carolina’s public employee plan is among the best-funded.

Plan	Funding Ratio (%)	Assets (\$000s)	Unfunded Liability (\$000s)
District of Columbia Teachers	100.0	917,800	–
District of Columbia Police & Fire	100.0	1,427,800	–
Maryland Teachers	92.8	20,155,415	1,568,763
North Carolina Teachers and State Employee	108.1	45,117,508	(3,383,806)
North Carolina Local Government	99.3	12,364,380	91,124
South Carolina Retirement System	82.8	20,197,936	4,200,995
Virginia Retirement System	96.4	39,243,000	1,455,000
West Virginia Public Employee Retirement System	80.0	3,095,660	774,541
West Virginia Teachers	22.2	1,427,475	5,013,263

NOTE: Figures as of 6/30/04 except D.C., 9/30/04.

SOURCE: National Association of State Retirement Administrators

and even into 2000. But it quickly reversed course as the market soured.

Meanwhile, its expectations about the future are decidedly conservative, most years assuming returns of 7.25 percent. (In the Wisconsin Legislative Council's survey, North Carolina's return estimate was tied for second lowest with South Carolina among 85 major public pension plans.) Additionally, North Carolina government employees pay into the Social Security system, and are promised only about half of their top salary after even 30 years of service — generous but not in league with plans that offer 75 percent to 95 percent of their top salaries. "We have worked very hard to keep all of our expectations and assumptions realistic in North Carolina," Moore says. "That's why we're in such great shape."

Also, Moore says it's cheaper to manage a defined benefit plan. His office spends 10 basis points per total assets on managing the fund, compared with about 70 basis points for a defined contribution plan. And investment returns tend to be higher, Moore says, thanks to the state's investment strategy that is strict in its adherence to asset allocation, unlike how many individuals pick stocks.

Some of these strategies have gained notice in other states with pension problems. Last year, West Virginia's legislature voted to require that public pension plans be at least 85 percent funded before allowing enhancements in benefits to active employees. Additionally, benefits improvements to retirees must now be amortized over six years, a relatively short time that was picked to make sure they are paid for quickly. A recent special appropriation added \$225 million to the public safety pension plan, allowing it to go from 25 percent

funded to almost 75 percent funded.

"I think the West Virginia Legislature, at least for the last 10 years that I've been here, has been very dedicated to funding all of our retirement system," says Terasa Miller, acting executive director of the state's Consolidated Public Retirement Board.

Money Management

Ed Husted, a former chief actuary at the Federal Office of Personnel Management who now works with Hay Group, a consulting firm in Washington, D.C., says that his general philosophy is to favor defined benefit plans. But sometimes that thinking changes, he says: "In talking to an employer and saying, 'Here is what a defined benefit plan is costing in terms of your contributions and risk and administration expense — and oh, by the way, the new employees don't appreciate it — maybe you should go with a defined contribution plan.'"

At the same time, Husted worries about shifting too many employees to defined contribution plans. The masses simply can't be trusted to responsibly plan for their retirement, he says. "The benefit produced by a good defined contribution plan invested wisely is still not going to be much higher than a defined benefit plan," Husted says. "And it could be a lot lower if people don't put as much in as they should or they make bad investment decisions." That sentiment is shared by North Carolina Treasurer Richard Moore, who says: "Individuals are not very good at managing their own money."

The case of West Virginia's teachers' pension plan, the one that is today only 25 percent funded, is illustrative on this point. When it was launched in 1941, the West Virginia teachers' plan

was a defined contribution fund. In the 1960s, many retirees started complaining that they had run out of retirement income, so legislators began the conversion to a defined benefit plan, thinking this would offer more protection to their retirees. But in making the switch, legislators continued to fund it as a pay-as-you-go defined contribution plan, instead of pre-funding it with an actuarial reserve. The result was a "systematic accumulation of staggering unfunded accrued liabilities," according to the 1991 annual report of the West Virginia Teachers Retirement System. In other words, in trying to protect their retirees from unwise planning, West Virginia lawmakers ended up making poor decisions themselves.

Converting public pensions to defined contribution plans would eventually take all the financial risk of public employee retirement off a government's books. But defined benefit plans remain the norm, in no small part — according to their managers — because they are a great benefit. They are guaranteed and people can't mess them up through dereliction or poor choices. "You're not leaving the employee out there to hang," says NASRA's Brainard.

But you are counting on pension managers and policymakers to take great care in the way they plan for the future, even though they probably will be long gone when the decisions they make begin to show results. In some cases, this has worked well. In other cases, like in West Virginia, it hasn't. No system is risk-free. And for many, the choice between defined benefit and defined contribution plans comes down to a simple question: Who do you believe will do a better job planning for retirement — the employer or the employee? **RF**

READINGS

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