Retirement Reform II: Beyond the Easy Stuff

Essential and practical steps to take in 2012

BY: Girard Miller | April 5, 2012

If you were to believe recent legislative reports chronicling "action" on pension reform, you would think America's states and cities had the problem almost whipped. According to the latest tally by the National Conference of State Legislatures, 43 states have now adopted some kind of pension reform since 2009. With all that activity in the state capitols, the average Joe must wonder why there is so much noise from reformers about a "public pension apocalypse."

Without becoming the Grinch, I'd like to dispel illusions — while also painting a less gloomy picture than we faced in 2009. Retirement reform efforts are best grounded in stronger probabilities, instead of false hopes or hysteria. I've also detailed the necessary steps to put pensions and OPEB in a more stable condition — before the next cyclical recession strikes sometime later in this decade. Many of these steps have yet to be taken.

Making progress. Good work has been done in some states where major changes have been enacted. Rhode Island comes to mind as a state that has tackled head-on the massive funding problems facing its state pension plans. (Of course, they still haven't fixed their municipal plans, and the receiver for tiny Central Falls has suggested that more communities there will still need to seriously consider the "nuclear" bankruptcy option to achieve pension reform.)

In several other states, the plan features now provided for new employees appear to be more affordable, sustainable and sensible. "New tier" pension multipliers for new hires have been whittled down to realistic levels in a few states. Hybrid plans are popping up. The Utah hybrid choice model has attracted a lot of attention in some circles, as did the Michigan teachers plan. Recent proposals that cleared one house in Kansas — to give new employees a choice between a cash-balance plan and a pure defined contribution option — are noteworthy. Retirement ages for new employees have been aligned with Social Security in several states, and that's clearly a step in the right direction of long-term cost control.

Several legislatures have also raised the employees' contributions where permitted by constitution, to help their employers dig out of a very deep financial hole by sharing the burden for mounting pension costs. NCSL noted that in ten states, the employee contributions have helped offset employer costs.

I also want to applaud efforts by a dozen or more major unions in several states and localities that have collectively bargained what I would call substantive reforms and notable increases in employee contributions. A few have even begun to address the OPEB (retiree medical plan) problem with employees. They are sharing in part of that cost in order to retain this benefit, a benefit that is becoming increasingly scarce in the private sector. But public support has clearly withered for those who retire early with lifetime medical benefits that most taxpayers will never see.

I am hopeful that we'll see some serious reform proposals take root in other states. The California governor's 12-point pension reform legislation is a worthy effort. Right now it is being roadblocked by unions that dominate both houses, but the Democrats there may yet cough up a pension-reform measure in order to persuade voters this November that a tax increase proposal is not just throwing good money after bad. In Tennessee, the state treasurer has proposed some thoughtful measures to offer local governments a full menu of flexible and affordable retirement plan options for new employees. All of those efforts are worthwhile and should be encouraged.

Also on the positive side, the U.S. economy has apparently turned the corner on its economic recovery, so the investment outlook has improved. Stocks are up, returning to 2006 levels (back when pension and OPEB liabilities supported by those assets were 25 to 30 percent lower than today). Barring the multitude of global risks that could blow up our stock market (Iran-Israel-Hormuz, Portugal-Spain-Greece II, or China-China-China), the historical odds now favor American equities gaining 10 to 15 percent annually until the next cyclical recession spoils the party sometime later in this decade. Pension funds can reasonably expect to beat their actuarial assumptions until the next downturn, and thus I expect to see funding ratios improve for a few years, as unfunded liabilities decline on a market-value basis. It's reasonable to expect that public pension funding ratios (at market value) could improve by 2 to 3 percent each year if and as the economy expands, and less than that if economic growth is impaired by overhanging global, governmental and household debt. But don't kid yourself into thinking we can get to full funding in this decade by market action alone.

My highest-probability scenario thus suggests a less gloomy outlook for employer pension contributions for plans that have been upfront with the public about their investment assumptions, funding policies and the depth of their problems. In fact, the policy risk now is complacency — that pension professionals, their lobbyists, elected officials and the public will be lulled to believe that the problem will be fixed by Mr. Market's normal cyclical benevolence and the irresistible illusion that trees will once again grow to the moon. The last two bubbles have hopefully taught us all the fallacy of such thinking.

It's also very important that policy-makers and the public understand that all the reforms enacted for new employees won't move the dial on accumulated unfunded liabilities. Pension debt and OPEB debt just sits there, waiting to be paid off before today's employees all retire and leave future taxpayers holding the bag while they simultaneously pay for the services of the next generation of public workers. The retrenchment and reductions in work force required to pay the mounting retirement bills will minimize any immediate positive effect of "new benefits tiers." Saving 20 percent of normal costs for new hires means nothing when there are few or no new hires. And so far in this New Normal economic recovery, state and local government employment has been shrinking, not growing.

Let's get serious. Despite the good intentions, hard work, and pragmatic progress that these various efforts represent, the retirement plan reforms mentioned above are but a drop in the bucket when it comes to fixing the massive unfunded liabilities that states and municipalities still face. It's especially noteworthy that the NCSL data show very little progress on retiree medical benefits (OPEB) reforms because those plans are typically employer-specific and not statewide. We still have a funding deficit that exceeds $2 trillion using conventional mainstream calculations. The deficiencies exceed $4 trillion if you value the pension and OPEB liabilities using standards required by the federal government for major corporate pension plans.* I have yet to see a serious proposal by anybody in the public pension community or the union bloc that honestly addresses the magnitude of these numbers — which seriously undermines the inference that legislative reforms to date have addressed the problem.

Time will soon run out in this cycle, even though the economy is just now getting on its feet in most states and localities. To understand my hard-headed views, one must understand the basic nature of business cycles and market cycles. Sadly, the traditional experts in the pension world don't pay much attention to the business cycle. They overlook the obvious because they have been trained to ignore the elephant on the table and how it moves.

Once a graduate-level economics major, I understand the problem here. Professors can't use statistical math to explain business cycles — those irregular waves of expansion and contraction defy the elegance that PhDs can display by using what are called stochastic (or parametric) tools. There is no way for the math wizards who practice traditional actuarial science, econometrics or capital markets investment analysis to explain what happens in the real world — which is the business cycle. They were trained to assume that investment returns are randomly distributed around a linear long-term trend line.

For those lacking an understanding of the business cycle, you can read Chapter 8 of my GFOA textbook

Investing Public Funds for a concise summary and references, or just search the Internet for classic works by Schumpeter and others who followed him.

My second, unofficial "graduate degree in economics" came not from a college but from eight learned Wall Street economists and real-world investors I polled monthly when editing a public-sector professional association investment newsletter I founded in 1983. What they taught me is that market cycles follow the business cycle and it's not entirely a random walk. Recessions bring stock prices down an average of 30 percent if you measure the last 14 cycles since 1926. That's the down cycle that is rarely discussed in pension circles until it's too late. On the other side of the cycle, stocks have increased in value by about 10 percent annually over the past 86 years, but they grow far faster in the recovery and expansion phase of the business cycle — only to be knocked back down again in the next recession. Thus, the average annual return used for actuarial discounting is actually the rare exception, not the rule. So the odds of pension funds and OPEB plans hitting their annual expected returns in a given year are quite low: they overshoot or undershoot — and often by 10 percent or more in a given year. As the legendary Peter Lynch of Fidelity Investments (where I also worked in a prior life) would say: stocks will either gain 15-20 percent or lose 10-20 percent in a given year, but seldom will they return their historical average of 10 percent. If stock market returns were normally distributed on an annual basis, 10 percent would be the central tendency and this game would be really easy to play. But they are not. In fact, their distribution pattern is much flatter than a normal "bell curve" that statisticians hypothesize. And more importantly, they are not random in the way the stochastic statisticians who provide models to actuaries and investment consultants would lead us to believe. Nobody has ever devised a predictive or even a prescriptive model that's worth its salt, using traditional statistical techniques.

So now what? Obviously I can't predict the future and definitely won't hold myself out as clairvoyant. My underlying point in this column is that the business cycle has likely turned favorable but it won't last forever. So now is the time to prepare ahead for the next winter to take proper advantage of summer as it arrives, while melting away the ice-dam formed in the severe winter freeze of 2008. This means that pension trustees, budget officers and OPEB plan administrators must look ahead to the next inevitable recession and develop risk-management strategies to mitigate its consequences. Otherwise, today's baby-step pension reforms will simply result in a re-run of the Bill Murray movie "Groundhog Day," when the next recession again plunges funding levels to distressed levels that will be even harder to manage because half of the baby boomers employed in government will then be retired and the demographics become really ugly.

Prudent public policy now requires three key strategies: (1) Pension funds must amortize their unfunded liabilities far more aggressively than their current schedules now require, (2) public employers must begin funding their OPEB plans actuarially and stop their head-in-the-sand practice of paying only the cost of the retirees' benefits while putting away zero for the cost of rapidly accruing benefits and (3) unsustainable benefits plans must be changed for current employees, whether it requires benefits changes going forward or an increase in employee contributions. Public-sector managers must take the lead in advancing and implementing these concepts because nobody else can do that job — and policy-makers will first need to be educated on the issues.

Pension amortization and cost-sharing. Step 1 for the pension funds is to begin amortizing their unfunded liabilities over the remaining lives of current workers. I addressed this issue last month in my column on intergenerational equity.

For most retirement plans, today's elongated amortization schedules won't restore the funding ratios fast enough to prevent a dismal Groundhog Day scene in the next recession, so employer and employee contributions must be increased even higher than most plans now require. At the same time that employers step up to full actuarial and intergenerational funding, they have every right to ask employees to step up to the plate with increased contributions to share in the cost of paying down the unfunded liabilities for their benefits. This won't be an easy break from tradition, because there is often a strong sense of entitlement to receive risk-free benefits without paying for them, but the enlightened unions will recognize that without higher contributions from employees, the alternative outcome is hiring and pay freezes for the rest of the decade — and a risk of taxpayer backlash in the next off-year election.

OPEB reform at last. Step 2: As the economy recovers, the time has finally come for public employers to gradually begin funding their OPEB (retiree medical benefits) plans actuarially and bargain much harder for employee contributions to share the burden. This requires establishing an OPEB trust fund to protect the employee contributions, and an employer contribution for the rest of the actuarial cost. Savvy employers will drive harder bargains with the unions to seek lower total benefits costs through reforms of their OPEB plan structure while they also demand an employee contribution that increases each year during the life of the next labor agreement. Retiree medical benefits often enjoy fewer constitutional and contractual-law protections than pensions, so this is now the low-hanging fruit in the labor arena in 2012.

Failure to address unfunded and unsustainable OPEB plans while the economy is expanding is a "pathway to hell," as the liabilities continue to mount and the cost of fixing the mess after the next recession will be double the cost of biting the bullet now. The math is compelling: Just ask your actuary to run the numbers on what your costs will be if you start funding now versus a delayed start in 2020.

Retirees and baby boomer workers read the newspapers and the internet. Many are becoming increasingly worried that their public employers really might not have sufficient money in the future to pay for their promised retiree medical benefits. As they see the increasing success of pension-poor cities playing the bankruptcy card in a few states, more of them will begin to recognize that OPEB plans must be properly funded. The smart ones will conclude there is more value in having (a) certainty of a reduced benefit than (b) uncertainty of an unsustainably generous benefit. But that requires strategic thinking to overcome inertia. Public leaders should read the brilliant behavioral economics work of Nobel laureate Daniel Kahneman in *Thinking, Fast and Slow* to understand how "prospect theory" can enlighten the bargaining in this arena.

Finally, there is a secondary budget-balancing benefit to start-up OPEB trust funds. They can serve as "closet rainy-day funds" by providing a place for employers to rightfully park budget surpluses with the understanding by policymakers that if another recession squeezes the budget, the OPEB trust can be used to pay for retirees' benefits without further budget contributions. That will increases budget flexibility dramatically in recession periods. A smart budgeter can make this work in the best interests of taxpayer groups that oppose building reserves that the unions will try to raid in their next arbitration hearing as "idle money" to pay for increased salaries and benefits. The unions can't touch an OPEB trust fund in arbitration. Smart funding of OPEB at this time in the cycle can accomplish multiple budgetary and financial planning objectives, and helps retain or restore good bond ratings. My advice for those who now pay-as-they-go is to "double up" the OPEB budget item and set aside the equivalent of a year's pay-go payments into a new OPEB trust, with the understanding it can be drawn down in a financial emergency if that is what it takes to get policy approval. After two years of repeating this strategy, the employer can then transition to full actuarial funding if and when budgetary conditions permit a longer-term policy commitment.

Address incumbents now. Step 3 is to study your state's laws concerning the vested rights of incumbent employees for both pensions and OPEB, and find the strategic path that yields maximum budgetary and actuarial benefits for the least pain and legal hassle. In some states, public employers enjoy the same rights as private companies to change benefits prospectively, but in others employees enjoy vested rights to maintain current benefits formulas and sometimes even the contribution rate. Contributions are often the most important budget-balancers for CFOs and chief administrators to address, where legally permitted — especially when they offset the employer's cost directly. In places like California where labor agreements went berserk with the concept of "employer paid member contributions" and in other states where the plan was established as "non-contributory," the employees have enjoyed a free ride or a nearly free ride. These arrangements have almost always led to inflated benefits. As I noted years ago in a prior column, Economics 101 informed us long ago that when the price of anything of value is zero, the demand is infinite.

So an increase in employee contributions may be the most rightful solution to burden-sharing by incumbent employees. This approach also reconciles with lower benefits tiers for younger workers, who should pay a lower contribution than their older counterparts in order to maintain workforce equity. And in states where prospective benefits reductions (such as lower pension multipliers for incumbents' future service) are lawful and appropriate, those should be pursued as part of the reform agenda.

Fix it now, for good. None of these prescriptions for prudent funding are easy. The "low hanging fruit" for retirement reform has been picked off. So now it's up to public officials to chart a course to full recovery from the distressed levels of plan funding we have experienced. This requires difficult choices that won't be popular in many circles. But failure to act now will buy public officials a ticket to the "Public Pension Groundhog Day Movie" that will be coming to local theaters at end of this decade.

**This column has been updated to indicate that the total deficiencies total $4 trillion (not $4 billion).*