Protecting Workers and Taxpayers: Improving State & Local Retirement Policy

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Retirement benefits are important.

• Everyone who works hard and plays by the rules should have a retirement plan that puts them on the path to retirement security.

• Retirement benefits are an important and valued part of workers’ compensation.

• Promoting workforce-wide retirement security is a worthy public policy goal.
My retirement policy work focuses on retirement security, sustainability, and transparency.

• I am an economist and retirement policy expert. I do research and write on the topic for the Manhattan Institute and lead the Laura and John Arnold Foundation’s retirement policy work.

• The Laura and John Arnold Foundation funds and works with a wide variety of grantees to produce policy papers and provide technical assistance to help policymakers understand important policy issues and create retirement systems that are affordable, sustainable, and secure.

• The Laura and John Arnold Foundation supports workforce-wide retirement security by helping governments improve plan funding policies and benefit design and by supporting efforts to expand retirement plan coverage.
Retirement policy has improved.

• Despite reports to the contrary, aggregate retirement savings has actually increased in the U.S.

• Retirement plan coverage and savings rates have remained roughly constant for decades.

• Still, there is work to be done to extend coverage to workers currently without access to plans, improve savings rates, and provide easier, less costly access to annuities.
Retirement savings has increased in the U.S.
Government pension promises are now 29 percent of U.S. GDP.

Source: Financial Accounts of the United States (Z.1) release, Federal Reserve Board of Governors, U.S. Department of Commerce: The Bureau of Economic Analysis (BEA), and authors’ calculations.
Unfortunately, public retirement benefits are underfunded by at least $1.3 trillion.

• Governments have failed to adequately pay for their retirement promises.

• Rising pension costs, particularly pension debt service costs, are straining state and local budgets.

• Services have been cut, and workers have been forced to endure benefit cuts, wage freezes, and job reductions.

• By taking steps to address the issue today, we can prevent a crisis tomorrow.
Public pension debt is larger than it has ever been.

Source: Financial Accounts of the United States (Z.1) release, Federal Reserve Board of Governors, U.S. Department of Commerce: The Bureau of Economic Analysis (BEA), and authors' calculations.
Retirement contributions have nearly tripled since 2001.

Source: Public Plan Database, Center for Retirement Research at Boston College, and authors’ calculations. Note: Shown is the weighted average across state and local plans. Sample consists of 109 state-administered plans and 17 locally administered plans.
Governments are paying more for legacy costs, leaving less money for current and future workers.

Note: Seasonally Adjusted. Data indexed to the trough of the recession, declared as June 2009 by NBER.

Chart 2 Source: U.S. Department of Commerce: Bureau of Economic Analysis, and authors’ calculations.
Note: Seasonally Adjusted. Data indexed to the trough of the recession, declared as June 2009 by NBER.
Funding and investment practices are likely to leave plans in a precarious position for decades.

• Repayment of pension debt is generally stretched over 30-years or more and payments are backloaded.

• Pension funds are more heavily invested in risky assets than ever before.

• Since 2006, public retirement plans have more than doubled the share of assets invested in alternatives.

• Public plans are expecting markets to yield a return that is almost three times larger than it was in the early 1990s relative to risk-free rates.
Governments are making riskier bets with workers’ retirement savings.
What is the situation in Louisiana?
Louisiana’s pension assets are not keeping pace with liability growth. This should be cause for concern.

Source: Public Plans Database at the Center for Retirement Research and authors’ calculations.
Volatile investment returns are part of the story.
Another piece of the story is an ARC that is too low and underpayment in recent years.

Source: Public Plans Database at the Center for Retirement Research and authors’ calculations.
Now over 80 percent of Louisiana’s annual contributions go to pay debt service rather than for new benefits.

Source: Public Plans Database at the Center for Retirement Research and authors’ calculations.
Louisiana’s retirement benefits are also backloaded.

Source: TRSL plan documents and authors’ calculations.
Policy makers should consider the effect of backloaded benefits on all workers.

Source: TRSL plan documents and authors’ calculations.
What should policymakers seek to accomplish?
What should be the goals of pension reform?

• Pension reform should establish:
  
  • A fair, workable plan to pay down the accumulated pension debt as quickly as possible;
  
  • Responsible, prudent funding and investment policies; and
  
  • A retirement savings system that is affordable, sustainable, and secure.
Key Retirement Plan Principles

- Retirement savings plans should incorporate principles in three key dimensions:
  - Retirement Security
  - Fiscal Sustainability
  - Transparency and Accountability
Retirement Security

• Retirement savings plans should place all workers, regardless of tenure or when they were hired, on a path to a secure retirement.

• Retirement savings plans must help workers:
  • Accumulate adequate retirement savings across their entire careers.
  • Have access only to professionally managed, low-fee investment options with appropriate asset allocation.
  • Have access to lifetime income options (annuities) upon retirement.
Fiscal Sustainability

• Retirement savings plans should remain financially sustainable across multiple generations of workers and taxpayers.

• Plan sponsors must:
  
  • Fully pay for their retirement promises in a responsible, sustainable way.
  • Establish a funding target of at least 100 percent.
  • Adopt closed amortization schedules of 20 years or less.
  • Adopt a discount rate for funding that is based on the risk-free rate plus an explicit risk premium.
  • Pay the full actuarial cost every year.
  • Use appropriate assumptions, which consider risk and the sponsor’s ability to pay for future shortfalls.
  • Be informed about the potential for and have an ex ante plan to deal with cost uncertainty.
Transparency and Accountability

• Retirement savings plans must have governance structures that ensure key decisions related to investment allocation, benefit design, and choice of assumptions represent the interests of all stakeholders and are made in a transparent and publicly accountable fashion.

• Plans must have:
  • Representative boards of trustees with a fiduciary duty to preserve plans’ long-term sustainability.
  • Boards must include investment experts and consider investment risk relative to the plan sponsor’s ability to pay.
  • A process to openly share data about the plan, its participants, and its fiscal condition.
There is no one-size-fits-all solution for improving state and local retirement policy.

• Paying down the accumulated pension debt must balance current budgetary constraints with intergenerational equity.

• Funding and investment policies should ensure that the full cost of earned benefits is paid and that cost uncertainty is not larger than the sponsor is able to bear.

• Retirement savings plans should help all workers reach retirement security. All plan designs can incorporate basic elements that support retirement security, including:
  • Adequate savings/benefit accrual rates;
  • Pooled, professionally managed, low-fee, and appropriately allocated investments; and
  • Limited lump sums and favorably priced annuities upon retirement.
Data and evidence should inform retirement policy.
(i.e., do not be fooled by assumptions and myths)
What does the evidence say?

• The Final-Average-Salary Defined Benefit (FAS DB) plan design is not the most cost-effective retirement plan model.

• FAS DB retirement plans often do not help all workers reach retirement security.

• FAS DB retirement plans do not facilitate recruitment and retention better than other retirement plan models.

• Moving to a different retirement plan model does not result in large transition cost or harm the legacy plan.
The FAS DB retirement plan design is not the most cost-effective retirement plan model.

- All retirement plan designs can incorporate pooled, professionally managed, low-fee, and appropriately allocated investments as well as annuities.
- Empirical evidence clearly shows that other plan designs have delivered similar investment performance at similar cost to FAS DB plans.

References:

FAS DB retirement plans often do not help all workers reach retirement security.

• Under FAS DB, workers often earn small benefits through much of their careers.

• Many workers leave before earning a more secure benefit.

• References:


FAS DB retirement plans do not facilitate recruitment and retention better than other retirement plan models.

• The structure of retirement plans appears to play very little role in recruitment.

• FAS DB plans have a strong “pull” effect near retirement eligibility and a “push” effect thereafter, but the “pull” appears to be pretty localized.

• In any case, there is no evidence to suggest that other well-designed models would harm recruitment or retention.

• References:
Moving to a different retirement plan model does not result in large transition cost or harm the legacy plan.

- How new employees earn benefits going forward has no effect on past benefit promises or how the sponsors pay for them.
- The plan sponsor is solely responsible to pay for any underfunding, and just like any debt, must responsibly pay it off over a reasonable timeframe.
- Contributions from/for new employees will generally be small relative to plan assets for decades and thus will have a trivial impact on plan cash flow and liquidity.

References:
Closing Thoughts

• Everyone who works hard and plays by the rules should have a retirement plan that puts them on the path to retirement security.

• Governments have failed to adequately pay for their retirement promises, and rising pension costs are straining state and local budgets.

• Workers are bearing a significant share of rising costs, and stand to loose the most if retirement policy does not improve.

• By taking steps to address the issue today, we can prevent a crisis tomorrow.