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Considering Municipal Pension Reform: Lessons from *Keeping the Promise: State Solutions for Government Pension Reform*

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I'm very pleased to have the opportunity to speak to the House Committee on Financial Liabilities Reform on the topic of municipal pension reform. My Name is William Freeland and I am an Economist and Research Analyst for the American Legislative Exchange Council's Center for State Fiscal Reform. The American Legislative Exchange Council works to advance the fundamental principles of free-markets, private enterprise, limited government, and federalism at the state level through a nonpartisan public-private partnership of America's state legislators, members of the private sector, and the general public.

I'm pleased to share with you the results of ALEC's recent study, *Keeping the Promise: State Solutions for Government Pension Reform*. The study is designed as a handbook for state legislators looking to gain a deep understanding of state public pension systems, common flaws associated with public pension plans, and steps to reform and secure public pensions so that workers can have faith that they will receive the benefits they have been promised and the public can avoid higher taxes or inadequate government services due to growing legacy costs. I'd like to review some of the general conclusions of the study, share some of the case studies of state and municipal pension reform, and conclude with some principles for considering pensions reform. Drawing on our recent study, I'll be outlining the key shortcomings of defined benefit plans and why various reforms or more broadly, a move to a defined contributions system would be a major boon to taxpayers and public employees alike.

I would be remiss if I did not note early on in my remarks that Michigan has been a model of pension reform for the entire nation in the wake of its late 1990s reform of pension plan for state employees. Michigan policymaker's decision to move from a defined benefit plan to a defined contribution plan for new workers was a common-sense, pragmatic solution at a time that the state was facing $4.1 billion in unfunded pension liabilities. Pension expert Richard Dreyfuss crunched the number in 2011 for the Mackinac Center for Public Policy and found that the state had saved $167 million in normal costs and between $2.3 and $4.3 billion in additional accrued unfunded liabilities.[1] Most importantly, the 1996 pension reform secured the retirement income of thousands of employees in a fiscally responsible manner.

[1] Richard Dreyfuss, Mackinac Center for Public Policy. "Estimated Savings From Michigan's 1997 State Employees Pension Plan Reform." http://www.mackinac.org/archives/2011/2011-03PensionFINALweb.pdf

Notwithstanding this success, Michigan policymakers are right to consider further reform to municipal pensions, particularly in the wake of recent municipal bankruptcies where pensions have played a central role in fiscal stress—most notably, Detroit. Detroit's insolvency has posed a legal challenge to the constitutional guarantee of public pensions and as such, it is even more pressing that the state examine reforms and mechanisms that ensure that every public employee receives the pension benefits they were promised. In considering reforms to municipal pensions, it's worth reexamining the short-comings of defined benefit plans and why defined contribution plans serve as an able solution to these pension problems.

As a brief refresher on the types of pension systems, I'd like to outline the details of 3 types briefly: defined benefit, defined contribution, and cash balance. The traditional definition of a "pension" is a defined benefit plan, in which the employer obligates itself to pay the employee in retirement. In a defined contribution plan, the employer makes certain payments into an employee's account during that person's tenure on the job; the employer's obligation ends, however, once the employee leaves the job. In a defined benefit plan, the employer is obligated to make a series of payments to the retired worker, regardless of how small the investment returns were. In a defined contribution plan, the employer makes no promises as to the amount of money the retiree will have. In a defined benefit plan, the employer decides how to invest retirement funds; in a defined contribution plan, the employee usually decides.

The third major type of an employer-sponsored retirement account, the cash balance plan, has qualities of both defined benefit and defined contribution plans. As with a defined contribution plan, the money a person has for retirement in a cash balance plan is tied to how much was contributed during his or her time on the job, not a formula. Even so, cash balance plans are, on the whole, more like defined benefit plans than not. The most significant similarity is that both plans obligate the employer to make monthly payments to the retired worker. Also, with both cash balance and define benefit plans, the employer decides how much money to contribute and how it is invested. Table 1 below from our recent study details some relevant differences:

Table 1: Overview of Retirement Plans
Comparing the features of defined-benefit, defined-contribution, and cash-balance plans

Feature	DB Defined-Benefit	DC Defined-Contribution	CB Cash-Balance
When does the employer's obligation to make payments end?	Lifetime of the employee, and perhaps a survivor	Worker's tenure on the job	Worker's tenure on the job
Does the retiree receive a COLA?	Often	No	Maybe
What does the employee receive upon retirement?	Promise of a fixed monthly payment	A lump sum that may be converted to an annuity or drawn down, as with an IRA	Promise of a fixed monthly payment
Who selects the investments?	Employer or designee	Employer, or employee acting within limits set by the employer	Employer
How is the benefit calculated?	Years of service, service credit (percentage of salary), average high salary	Percentage of salary deposited over time, with earnings and (perhaps) matching funds	Percentage of salary credited to a "hypothetical account," plus an interest rate set by the employer
Does it reward longevity or mobility?	Longevity (generally)	Mobility (generally)	Either
Can the employee supplement money contributed by the employer?	No (generally)	Yes	No (generally)
Who bears investment risk and reward?	Employer	Employee	Employer
Does the employee have a legal claim on employers who do not make annual contributions?	No	Yes (if the plan calls for the employer to make contributions)	Yes

The key issue related to public pension plans is the cost to taxpayers and there are two relevant types of costs: the normal cost and the cost of unfunded liabilities associated with the plan. The normal costs are those outlays associated with funding employee retirement plans every year in order to later pay benefits out to retirees. The unfunded liability costs are the pension plan debt that is the result of defined benefit plans that have been underfunded, contained assumptions about investment growth that are two rosy, or otherwise compromised with fiscally imprudent decisions. It worth noting that across the country and in Michigan's remaining defined benefit plans, the cost of unfunded liabilities is large and has predominantly been growing.

Today, I'd like to focus extensively on the accrual and cost of unfunded liabilities. To quote our study's author, State Senator Dan Liljenquist:

The political facts of life mean that defined benefit plans are prone to "improvements" that weaken their finances. A legislator who pushes through an increase in the service credit gets a political boost today from public employees. The cost of that improvement, however, may not be felt until long after that person leaves office—a fiscal time bomb that other legislators, holding office years or decades later, must defuse. Given the increasing longevity of the American workforce, an act passed today to increase the value of a pension promise may have consequences that last 50, 60, or even 70 years. Defined benefit plans have a key shortfall: Their long-term health is subject to manipulation for short-term political gain. In addition, employers can never be sure of their long-term obligations under defined benefit plans that require payments for a lifetime or two.

Though many localities are certainly responsible stewards of their public pension system and have been fully funding their defined benefit system each year, it only takes a year or few years of pension underfunding, too-generous cost of living adjustments, pension contribution holidays, or pension plan investment returns below the

too-rosy assumed return, to accrue large pension debt that the municipality will likely be saddled with for decades.

Though I'll offer some suggestions for reform of defined benefit plans, it's important to make one point clear: though reforms can often improve the standing of defined benefit plans, there is no reform short of closing off defined benefit plans and moving to a defined contribution system that will remove these incentives that result in large unfunded liabilities. Though debt that has already accumulated cannot be shed, what can be done is the prevention of future pension debt accrual. That objective is best accomplished by a system that eliminates the dynamics that create pension debt and ensure that pensions are fully funded in a secure system irrespective of what leaders administer that system. Defined contribution systems ensure that 100% of pension funding must take place each and every year and eliminate the possibility of economic swings damaging a seemingly well-funded pension system.

Defined contributions plans keeps government honest. When a worker earns a dollar, he is paid by the employer for that dollar. But in a defined benefit plan that is improperly funded, when an employee earns a dollar, taxpayer's grandchildren pay the dollar. This arrangement is irresponsible to public servants and future taxpayers. Defined contribution plans ensure responsible public finances with respect to retirement benefits.

As our study details, many states have taken this exact step by closing their defined benefit plans and moving new employees to a defined contribution plan, or even freezing defined benefit plans and moving all employees over to a defined contribution plan. As I mentioned before, Michigan has been a shining example in this regard as the first state to shift over to a defined contribution plan in 1997, pushing all new employees into a defined contribution system. Alaska did similarly in 2006. In 2011 Utah, led by our studies author, State Senator Dan Liljenquist, gave new employees the option of a defined contribution plan or a hybrid system heavily leaning on a defined contribution plan. In 2012 Kansas reformed their defined benefit system by converting it into a cash balance system with strong constrains on fiscally irresponsible practices. Rhode Island in 2011 moved many employees over to a hybrid plan and implemented strong reforms to the defined benefit portion of the hybrid plan.

The non-profit fiscal policy watchdog, State Budget Solutions, has calculated total unfunded state and local pension liabilities across the nation at $4.3 trillion.[2] In the face of this mounting debt, these before mentioned states have reformed their pension system and many more or are considering reforms.

I'd like to reiterate that moving to a defined contribution plans is the strongest and most responsible reform that a state can implement and briefly address one common criticism of a move to a defined contribution plan. Many critics suggest that so-called "transition costs" make moves to defined contribution plans fiscally irresponsible. As ALEC's recent pension study and a recent paper by the Arnold Foundation both point out, transition costs are largely a mirage[3]. These are not costs in the sense that they are new financial obligations, but instead an optional recalculation of already incurred pension debt. This is debt that is the result of past underfunding and not the result of the moving to a defined contribution plan. That debt must be paid somehow eventually and closing a defined benefit plan simply makes the proverbially "kicking the can down the road" a more transparent action.

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[2] Cory Eucalitto, State Budget Solutions. "Promises Made, Promises Broken - The Betrayal of Pensioners and Taxpayers." http://www.statebudgetsolutions.org/publications/detail/promises-made-promises-broken-the-betrayal-of-pensioners-and-taxpayers#ixzz2hFWEI6I2

[3] Josh B. McGee, Laura and John Arnold Foundation. "The Transition Cost Mirage – False Arguments Distract from Real Pension Reform Debates." http://www.arnoldfoundation.org/resources/transition-cost-mirage-%E2%80%93-false-arguments-distract-real-pension-reform-debates

Shy of moving to a full defined contribution plan, I'd like to suggest changed to defined benefit plans that will make these plans more resilient to fiscally irresponsible decisions:

- Require 100% of annual contribution be made to defined benefit plans.
- Use sensible investment assumptions below 7% annual return.
- Eliminate automatic cost of living increases and limit their size.
- Limit other post-employment benefit expenditures such as retiree health or life insurance.
- Eliminate "pension spiking" which is the process whereby employees are allowed to work overtime or trade in sick days in their final year of service and have that compensation count towards their final salary figure for the purpose of pension calculations.
- Place a hard cap on pension payouts as a percentage of employee salary.
- Increase age and service requirements.
- Raise employee contribution requirements.

These reforms will help to address the "normal pension costs" and may in part lead to more discipline in not accruing unfunded liabilities, but I'd like to repeat that these options are inferior to a move to a defined contribution plan. Defined contribution plans ensure 100% funding pension benefits every year and ensure that the fund does not incur pension debt later on due to bad investment growth assumptions or a market crash.

In terms of implemented these reforms, the Michigan State government certainly has a role in regulating and setting the acceptable terms of what types of pensions localities are allowed to offer, while still allowing for municipal autonomy. A rule limiting profligate practices or even outlawing defined benefit plans altogether would be a major step in the right direction towards sounder municipal budgets. Michigan policymakers would be right to consider such reforms for municipalities, consistent with their successful reforms for state employees in 1996.

In closing, I'd like to highlight the importance of these reforms for two groups: employees and taxpayers. For taxpayers, reforming pensions means that costly unfunded liabilities are stopped from accruing in the future, allowing taxes to be held low and preventing public services from being crowded out in the future. As Gina Raimondo, a Democrat and state treasurer during Rhode Island's recent pension reform, answered in response to a disgruntled public employee challenging the morality of pension reform, "I would ask you, is it morally right to do nothing [on pension reform], and not provide services to the state's most vulnerable citizens? Yes, sir, I think this reform is moral."

Moreover, reformatting pensions to a more sustainable system allows the state to make credible retirement promises to public employees that their municipal retirement will be there as promised and not cut due to financial bankruptcy. Public servants deserve to have predictable retirement systems and defined contribution plans allow them to have just that. A move to a defined contribution system does not cut or eliminate the benefits: it saves them from irresponsible funding practices.

I sincerely thank the committee for inviting me to testify and await your questions. Thank you.