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Voice

# Myth Information

*Three myths about state and local government pension plans*

**SIGNIFICANT MISINFORMATION IS** circulating in recent media reports about state and local government pension plans. These reports claim that most public pension plans are in a state of financial crisis, that they lack oversight and standards and, therefore, that they should be replaced with defined contribution plans.

## Myth 1: Public Pension Plans Are in Crisis

The claim that public pension plans are in crisis often is supported by references to a handful of poorly funded public plans and a statement that public plans' unfunded liabilities amount to hundreds of billions of dollars. In fact, pension plans covering the vast majority of public employees are in good financial shape. According to the Public Fund Survey, the average funded ratio for more than 100 of the nation's largest public plans was 87% in 2005, with two-thirds of the plans at least 80% funded. While a handful of plans do have funded ratios below 60%, the financial health of the plans covering the vast majority of public employees is sound.

While the Public Fund Survey reports unfunded liabilities of $336 billion, this represents only 13% of total liabilities for the surveyed plans. According to the US Federal Reserve, public pension plans as a whole have accumulated $2.7 trillion in assets to pay benefits. Furthermore, pension liabilities are long-term liabilities that are amortized over up to 30 years, similar to a mortgage. Homeowners who had paid 87% of their mortgages with 30 years to pay the remainder would not consider themselves in financial crisis.

These reports often give the impression that taxpayers pay all of the public pension benefits. However, most public plans require member contributions, and almost all public plans invest their assets and earn additional income. According to the U.S. Census Bureau, state and local pension plans accumulated $2.3 trillion in investment earnings from 1982 through 2005, compared with total employer (taxpayer) contributions of $885 billion and employee contributions of $435 billion. Consequently, taxpayers paid 24% of the total amount paid into public plans during this period, with the remaining 76% coming from investment earnings and employee contributions. Every dollar taxpayers paid into public plans generated an additional three dollars, to be returned to the economy as retirement income.

## Myth 2: Public Pension Plans Lack Oversight and Standards

Recent media reports suggest public plans are not subject to oversight, fiduciary requirements, or even accounting standards. In fact, all public plans are governed by federal and state laws that regulate how they are established and the level of benefits they can provide. Public plans also are governed by comprehensive accounting standards established by the Governmental Accounting Standards Board (GASB). These standards provide the framework for the annual financial audits most governments contract to independent accounting firms. Since credit rating agencies pay close attention to the auditor's report in assessing a government's credit quality, there is significant incentive to adhere to the GASB's standards.

While public plans are not subject to many of the provisions of the federal Employee Retirement Income Security Act of 1974 (ERISA), state fiduciary laws governing public plans often reflect ERISA's language. According to *Protecting Retirees' Money*, published by the National Council on Teacher Retirement, the fiduciary standards established by nine out of 10 states for their retirement plans are similar to ERISA's fiduciary standards.

## Myth 3: Converting to a Defined Contribution Plan Will Save Money

Media reports also suggest that replacing public pension plans with defined contribution (DC) plans (similar to 401(k) plans) would reduce government costs and better meet workers' needs. While DC plans are useful for supplementing pension benefits and encouraging additional employee savings, replacing public pension plans with DC plans is unlikely to reduce government costs or better meet workers' needs.

First, many state and local governments have strong legal protections on pension benefits—often based in the state's constitution. Consequently, the current pension plan still would need to be maintained and funded for current employees. Any new DC plan would be established for newly hired employees at an additional cost to the government. Moreover, because the pension plan would be closed to new employees, stricter accounting standards would apply, effectively increasing the plan's annual contributions. Any arguable savings from conversion to a DC plan would likely take 10 to 15 years to realize.

Second, DC plans have not been particularly successful at providing adequate retirement benefits. Many DC plan participants do not contribute enough to sustain their benefits throughout retirement, and often take money out of the plan when they change jobs. They also tend to invest conservatively, earning low returns while paying high investment management fees. Finally, they

often spend their assets too quickly in retirement. A 2004 Congressional Research Service study found that only half of older workers in 401(k) plans had accumulated enough to provide an annual benefit of at least $5,000. By comparison, public pension plans paid an average annual benefit of about $20,000 in 2005.

Third, to ensure they do not outlive their benefits, DC plan participants must contribute enough to pay benefits that will carry them into their 90s. However, because pension plans can pool these mortality risks, contributions need only fund benefits over the average life expectancy of the group (about age 85). Consequently, for the same level of benefit, contributions to a pension plan are significantly lower than to a DC plan.

This lack of mortality pooling in DC plans can affect women in a particularly negative manner. Their DC account balances tend to be lower than men's because of employment interruptions due to child rearing. In addition, because women generally live longer than men, they typically have to spread the smaller balance over more retirement years.

## The Impact of Current Trends on the Future Economy

The difference in retirement benefits paid through pension and DC plans raises a broad public policy question: What will happen to the US economy as more people retire? According to the 2006 Social Security Trustees Report, the US population age 65 and older will double over the next 25 years, from 37 million in 2005 (12% of total population) to 70 million (20% of total population) in 2030. It is likely that, as a result of the movement to DC plans, the income of many future retirees will be significantly less than their pre-retirement income. This could mean lower demand for goods and services, possibly for many years.

By providing sufficient and sustainable retirement income, public pension plans help support the US economy over the long term. They serve as financial engines, generating investment earnings from employer and employee contributions and returning the earnings to the economy as stable lifetime retirement income. A 2004 working paper prepared for the Pension Research Council at the Wharton School estimated that the higher investment returns generated by public pension funds, relative to DC plan returns, create an economic stimulus of 2.0% of GDP, or more than $200 billion, annually. This stimulus is continuous and steady, with the dollars produced by the higher returns distributed to local economies across the nation.

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## Steps To Improve Public-Plan Sustainability

While most public pension plans are in good financial condition, there are steps public plans can take to improve their sustainability, especially in light of the volatile investment environment. First, to reduce downside investment risk, plans should review their asset allocations in light of likely investment returns and the duration of their liabilities. Second, governments should avoid providing benefit increases based on plan "overfunding" or "excess assets." Third, governments should contribute consistently the amounts necessary to fund their pension plans and, if feasible, should establish reserves to help ensure contributions are made during cyclical economic declines. Finally, to the extent benefits cannot be sustained, new benefit tiers can be established to provide sustainable defined benefits for newly hired employees.

*—Paul Zorn/Keith Brainard*

*As research director for the National Association of State Retirement Administrators, **Keith Brainard** collects, prepares, and distributes to NASRA members news, studies, and reports pertinent to public retirement system administration and policy. NASRA members are the directors and administrators of 82 statewide public retirement systems in the United States. Combined, these systems hold assets of more than $2 trillion in trust to fund pension and other benefits for most of the 22 million working and retired employees of state and local government in the US. He previously served as manager of budget & planning for the **Arizona State Retirement System**.*

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