

RETHINKING TEACHER RETIREMENT BENEFIT SYSTEMS

**COMMENTS ON SESSION V:
LEGAL FRAMEWORK & GOVERNANCE**

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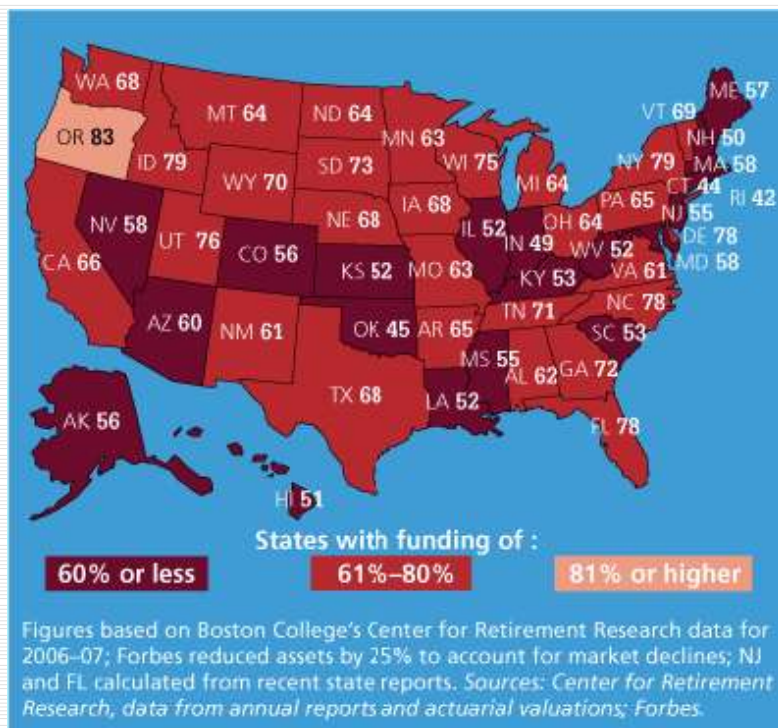
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Thank you for this opportunity to discuss these two fine papers. I generally agree with the authors, although both papers seem to favor the perspective of public employers and taxpayers over that of teacher-employees. Public pensions are long-term contracts between public employers and their employees, and those contracts should not be abandoned just because they have now become inconvenient.

State Pension Plans Are Underfunded



Perilous State, FORBES, February 16, 2009, available at <http://www.forbes.com/forbes/2009/0216/078b.html>.

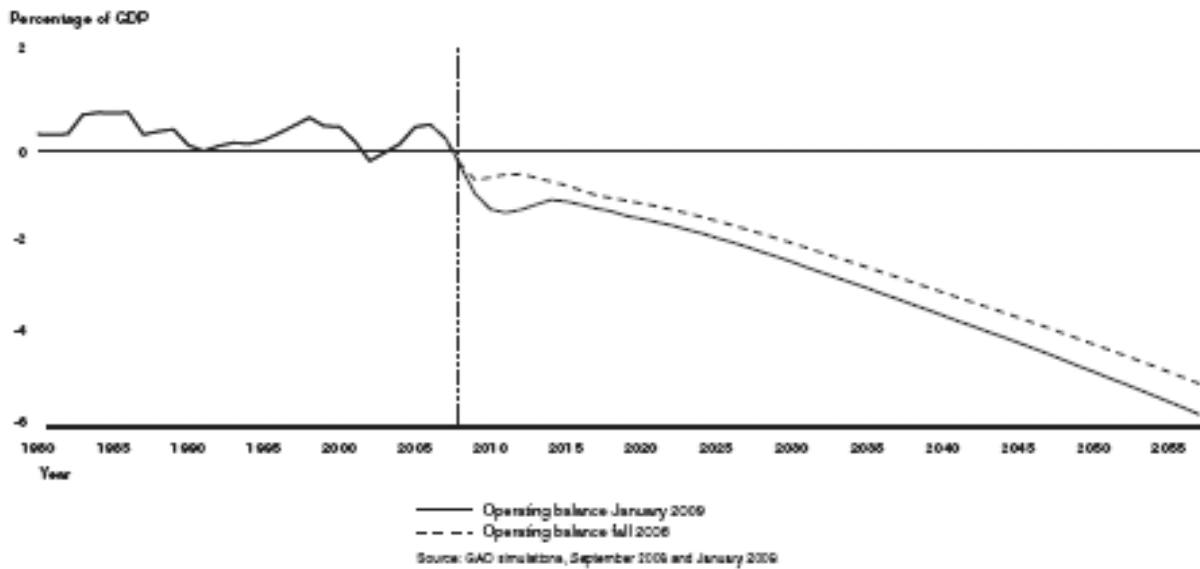
I. LEGAL LIMITATIONS ON PUBLIC PENSION PLAN REFORM BY AMY B. MONAHAN

Professor Amy Monahan's paper explains the legal protections for teacher pensions around the country. I mostly write about national retirement policy, because I hate doing 50 times as much work to review the laws of all 50 states. So I am grateful that Amy has done such an excellent job in

reviewing and categorizing the ways in which state laws have come to protect the pension benefits of public employees. Through state constitutional provisions and court interpretations of property rights and contract rights, most states essentially guarantee that their workers will get the pensions that they were promised when they were hired. The effect of this anti-reduction rule is that public employers can rarely cut pensions benefits for current workers or retirees. Instead, pension and benefit changes typically only apply to newly hired workers.¹

Insert worker, and wait 30 or 40 years to see any financial savings. No wonder Amy titles her paper, “Legal Limitations on Pension Plan Reform.”

Figure 1: State and Local Model Operating Balance Measure, as a Percentage of GDP



U.S. Government Accountability Office, *Update of State and Local Government Fiscal Pressures* (GAO-09-320R, 2009), at 3.

¹ See also U.S. Government Accountability Office, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs* (GAO-07-1156, 2007); National Conference on Public Employee Retirement Systems, *State Constitutional Protections for Public Sector Retirement Benefits* (2007), <http://www.ncpers.org/Files/News/03152007RetireBenefitProtections.pdf>.

Of course, I agree with Amy that this anti-reduction rule is unduly generous. States should never have promised such generous benefits unless they were willing to fund them contemporaneously.² But just look at the long run deficits.

Alternatively, state and local governments should never have promised these generous pensions without reserving the right to cut future benefit accruals.

But they did, and now they should honor them. Integrity—and contracts—are about doing what you promised to do even when it becomes inconvenient.

To be sure, all of us on the podium today believe that if you hire a worker to do a job today, you should pay all of the costs for that worker out of current revenues, not push the liability onto future generations of taxpayers.

Government Contributions Needed to Fully Fund State & Local Pension Benefits

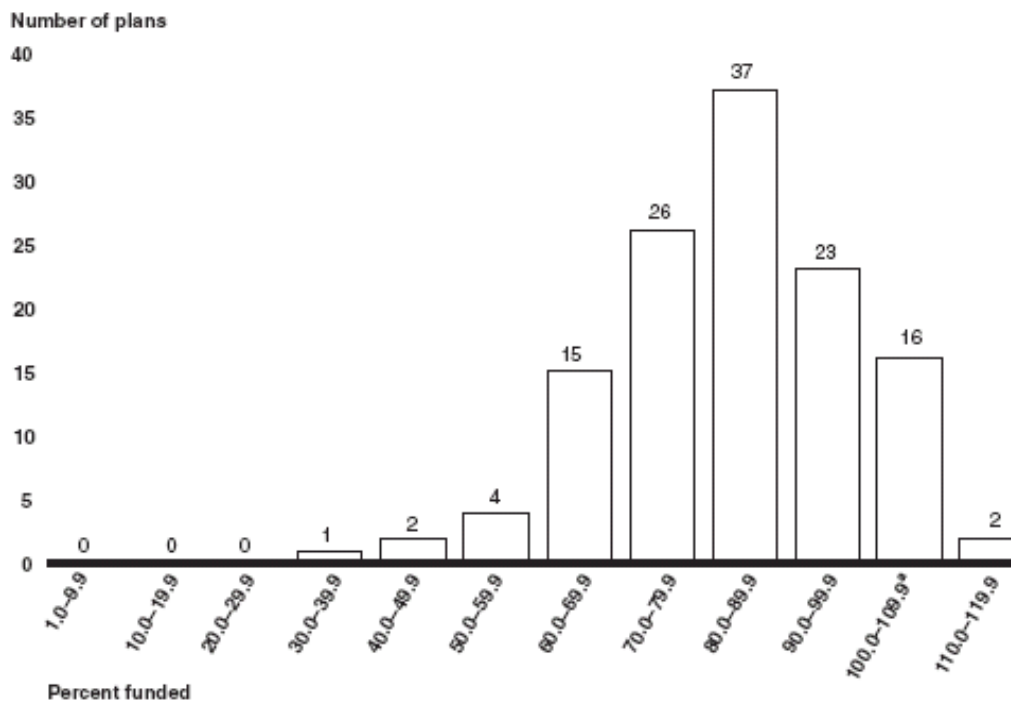
<i>Simulation assumption for the rate of return on investment</i>	<i>Projected government contribution level needed to fully fund the liability</i>	<i>Difference between projected contribution level and the actual 9.0% of salaries in 2006</i>
Higher return scenario: 6 percent real rate of return	5.0 percent of salaries per year	- 4.0 percent of salaries per year
Base case: 5 percent real rate of return	9.3 percent of salaries per year	+ 0.3 percent of salaries per year
Lower-return scenario: 4 percent real rate of return	13.9 percent of salaries per year	+ 4.9 percent of salaries per year

U.S. Government Accountability Office, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs* (GAO-07-1156, 2007), at 28.

² According to the Government Accountability Office, state and local governments will face operating deficits of about \$131 billion for 2009 and about \$181 billion for 2010 unless they make substantial policy changes. U.S. Government Accountability Office, *Update of State and Local Government Fiscal Pressures* (GAO-09-320R, 2009), at 2-3.

According to the GAO, state and local governments have been doing pretty well with their pensions. On average, they contributed about 9 percent of wages to pension funds in 2006, and they could have fully funded their pensions that year by increasing their contributions slightly—to 9.3 percent of wages.³ Unfortunately, if future rates of return are low or negative, then much higher contribution rates will be needed.⁴

Figure 5: Distribution of the Funded Ratios of 126 of the Nation's Largest State and Local Defined Benefit Pension Plans



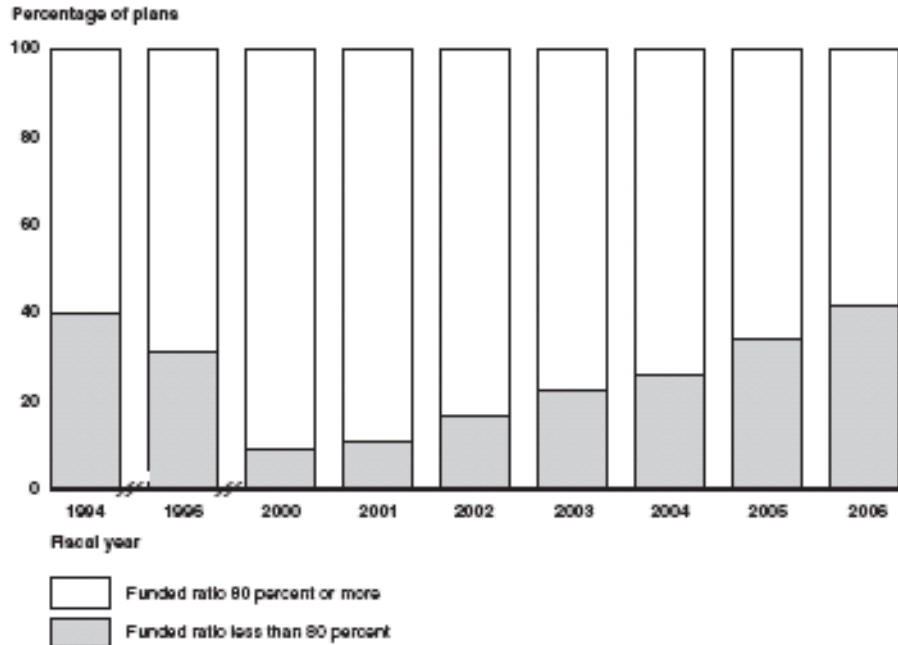
U.S. Government Accountability Office, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs* (GAO-07-1156, 2007), at 31.

³ U.S. Government Accountability Office, *State and Local Governments: Growing Fiscal Challenges Will Emerge during the Next 10 Years* (GAO-08-317, 2008), 49.

⁴ See also David G. Hitchcock & Robin Prunty, *Public Finance: How “Smoothing” Can Ease The Pain Of Pension Fund Losses For State and Local Governments* (Standard & Poor’s, 2009); Alicia H. Munnell, Jean-Pierre Aubry & Dan Muldoon, *The Financial Crisis and State/Local Defined Benefit Plans* (Center for Retirement Research as Boston College, Issue in Brief No. 8-19, 2008); Ted Hampton & Ida Chan, *Special Comment: Pension Funding May Suffer From 2008 Stock Market Declines* (Moody’s Investors Service 2008); *NASRA/NCTR Issue Brief: Market Declines and Public Pensions* (2008), http://www.nasra.org/resources/NASRA_NCTR_ISSUE_BRIEF0812.pdf.

According to the National Association of State Retirement Administrators, over three-fifths of the largest state and local pension plans were at least 80 percent funded in 2007—a level that is often said to be “healthy.”⁵

Figure 3: Percentage of State and Local Government Pension Plans with Funded Ratios above or below 80 Percent, by Fiscal Year



Source: GAO analysis of PFS, PENSAT data.

U.S. Government Accountability Office, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs* (GAO-07-1156, 2007), at 31.

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⁵ U.S. Government Accountability Office, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs*, at 30. Of course, funding levels varied dramatically across the 126 plans surveyed—from about 32 to 113 percent.

⁶ More than half of state and local governments’ plans reviewed by the Public Fund Survey (PFS) had a funded ratio of 80 percent or better in fiscal year 2006, but the percentage of plans with a funded ratio of 80 percent or better has decreased since 2000, as shown in figure 3. U.S. Government Accountability Office, *State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits*, 15-16.

But the only reason that anyone thinks that 80 percent funding is good enough for government is that we all recognize that when public plans get anywhere close to 100 percent funded, bad things happen.

First, beneficiaries will lobby for—and usually get—more generous benefits, thereby restoring the funding ratio to a bad but politically tolerable level. In Oklahoma, for example, the state provides much of the funds for primary education. At the same time, the Oklahoma Teachers' Retirement System is only 50 percent funded.⁷ Nevertheless, Oklahoma teachers spend most of their lobbying efforts chasing pay increases—that invariably worsen the funding ratio. When Oklahoma teachers do lobby about pensions, they usually just ask for more benefits; lobbying for larger government contributions is just an afterthought.

The second bad thing that happens to fully funded state pensions is that governors and their lackeys in their legislatures call for contribution cuts and holidays. As Frederick Hess and Juliet Squire's paper shows, politicians would rather spend money on projects that will bring them more immediate campaign contributions and votes.

I agree with Professor Monahan's major premise—that the Employee Retirement Income Security Act of 1974 (ERISA) provides a better rule for protecting pension benefits. Under ERISA's so-called anti-cutback rule, only earned pension benefits are protected. Employers are free to cut future benefit accruals or even terminate their plans, and we have witnessed many such freezes and terminations in the private sector.

⁷ Gabriel Roeder Smith & Company, Teacher' Retirement System of Oklahoma Annual Actuarial Valuation for the Year Beginning June 30, 2008 (2008) at 2 (showing a funding ratio of 50.5 percent as of June 30, 2008), <http://www.ok.gov/TRS/documents/2008%20Actuarial%20Valuation.pdf>.

States should immediately adopt constitutional amendments or statutes to adopt that anti-cutback rule for new workers. New workers should be able to count on pension benefits as they earn them, but states should be free to cut future benefit accruals for those new workers.

Amy suggests that some state courts might adopt an ERISA-style, anti-cutback rule, even without a constitutional amendment or statutory change. I hope that does not happen, at least not for current workers.

When we were young, we came to our teaching jobs knowing that government work paid less—but that benefits were more generous.⁸

Public and Private Sector Compensation, 2008

	<i>Cost per hour</i>	<i>Benefits (%)</i>	<i>Retirement and savings (%)</i>
<i>State and local government</i>	\$39.18	\$13.41 (34.2%)	\$3.09 (7.9%)
<i>Private Sector</i>	\$27.07	\$7.93 (29.3%)	\$0.79 (3.0%)

U.S. Bureau of Labor Statistics, *Employer Costs for Employee Compensation—September 2008* (USDL 08-1802, December 10, 2008).

⁸ State and local government workers comprised around 12 percent of the nation’s workforce in 2006. U.S. Government Accountability Office, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs*, at 1. State and local governments typically provide their workers with a traditional defined benefit pension plan, a supplemental defined contribution plan for voluntary savings, and a partially-paid health benefit. “In fiscal year 2006, state and local government pension systems covered 18.4 million members and made periodic payments to 7.3 million beneficiaries, payout out \$151.7 billion in benefits.” U.S. Government Accountability Office, *State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits* (GAO-08-223, 2008), at 4. According to the Census Bureau, there were 2,547 state and local government employee retirement systems in 2006-2007 covering 18,583,270 members (14,422,883 active and 4,160,387 inactive), and 7,463,567 beneficiaries were receiving periodic benefit payments. U.S. Census Bureau, *State and Local Government Employee-Retirement Systems: Fiscal Year 2007* (last revised December 29, 2008), Table 5, <http://www.census.gov/govs/www/retire07.html>.

Needless to say, a lot has changed since then. State and local government workers now make more than their private sector counterparts, and the gap is widening every year.⁹ In 2008, for example, compensation costs averaged \$39 an hour in the public sector but just \$27 an hour in the private sector.¹⁰

Changing Participation in the Private Sector

<i>Year</i>	<i>Defined benefit plans</i>	<i>Defined contribution plans</i>	<i>All retirement plans</i>
1985	80	41	91
1995	52	55	80
2000	36	50	70

Bryandt Rose Dickerson. *Employee Participation in Defined Benefit and Defined Contribution Plans, 1985–2000*, (2004), <http://www.bls.gov/opub/cwc/cm20030325tb01.htm>.

⁹ For example, from 2000 to 2007, public employees saw a 16 percent increase in compensation after adjusting for inflation, compared with just 11 percent for private workers. Dennis Cauchon, *State, local government workers see pay gains*, USA TODAY, February 1, 2008, http://www.usatoday.com/news/nation/2008-02-01-civil-servants_N.htm.

¹⁰ In September 2008 for example, employer costs for civilian workers average \$28.87 per hour. U.S. Bureau of Labor Statistics, *Employer Costs for Employee Compensation—September 2008* (USDL 08-1802, December 10, 2008). Private industry employer compensation costs averaged \$27.07 per hour worked—\$19.14 in wages and salaries (70.7 percent) and benefits of \$7.93 (29.3 percent). The average cost for retirement and savings benefits was 97 cents (3.0 percent). Employer costs in state and local governments averaged \$39.18 per hour—\$25.77 in wages and salaries (65.8 percent) and benefits of \$13.41 (34.2 percent). The average cost for retirement and savings benefits was \$3.09 per hour (7.9 percent).

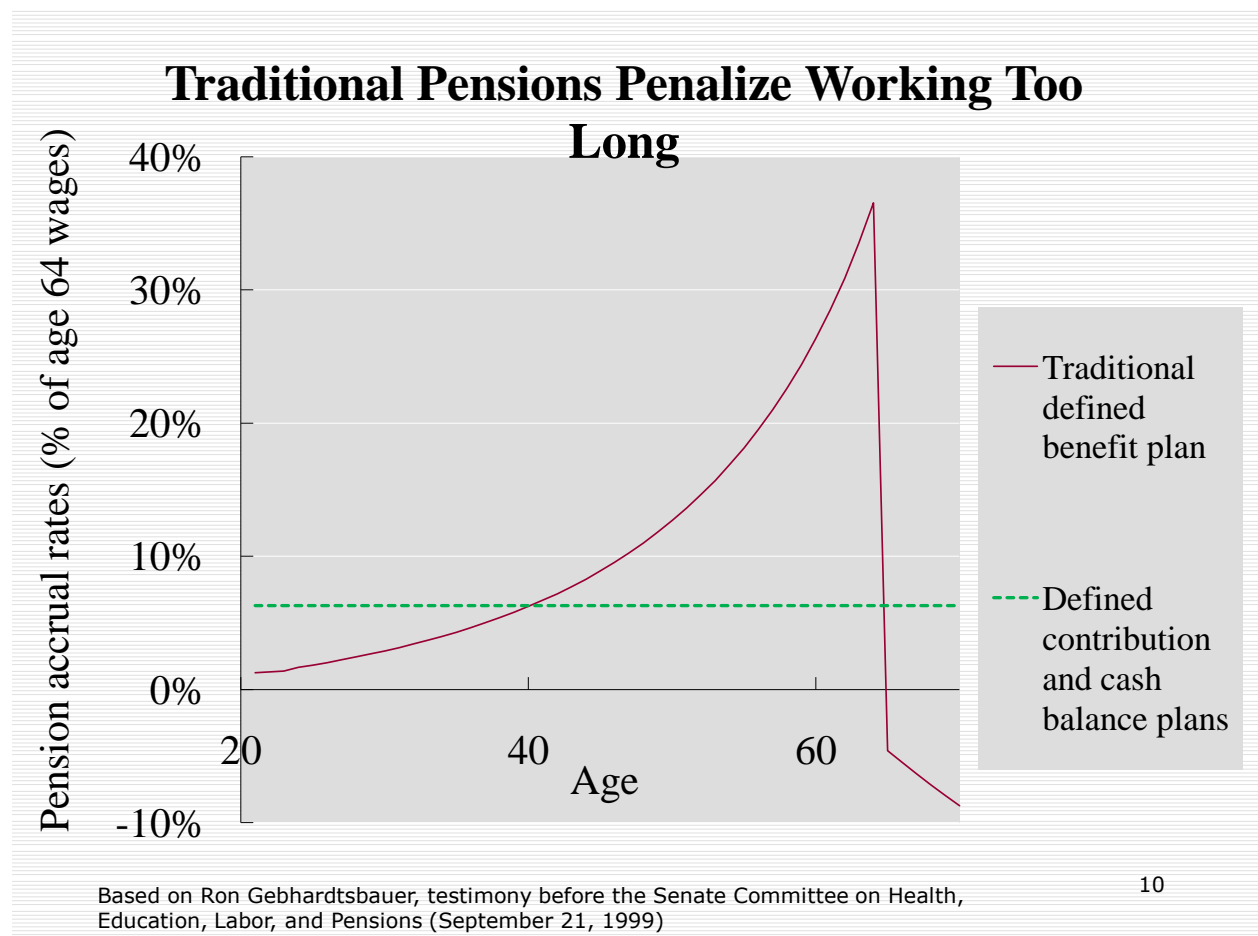
Public employees also tend to have traditional defined-benefit pension plans, while the private sector has all but abandoned them.

Still, the pension promise to current public employees is an implicit contract that should be honored.¹¹ Having underpaid us when we were young, state and local governments need to honor their commitments and give us with those generous pensions when we are old.

¹¹ See, e.g., Bernard Casey, *Incentives and Disincentives to Early and Late Retirement* (Organization for Economic Cooperation and Development, Working Paper No. AWP 3.3 1997).

II. “BUT THE PENSION FUND WAS JUST *SITTING THERE...*”: THE POLITICS OF TEACHER RETIREMENT PLANS BY FREDERICK M. HESS & JULIET P. SQUIRE

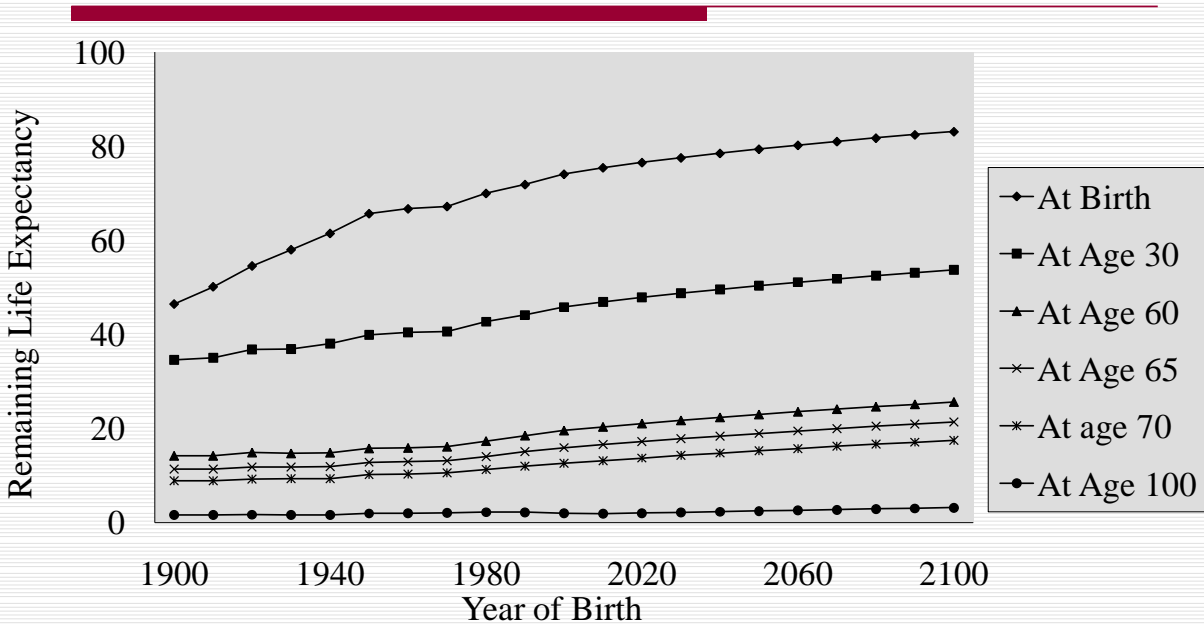
Moving on, Frederick and Juliet use public-choice theory and interest-group analysis to show how teachers and politicians can’t help but underfund public pensions. They also point to the governance problems of many public pension boards (though certainly not the one I serve on). These are all very serious problems that need to be addressed.



I also share Frederick and Juliet’s concern that traditional pensions have perverse incentives that encourage lousy teachers to stick around and get their generous pension benefits and that push great teachers into retirement just when we want them to keep teaching. Who wouldn’t stick around

to get those overly generous benefit accruals when you get close to retirement age, and who wouldn't quit when you face financial penalties for staying?

Remaining Life Expectancies for Males at Various Ages, from 1900 to 2100



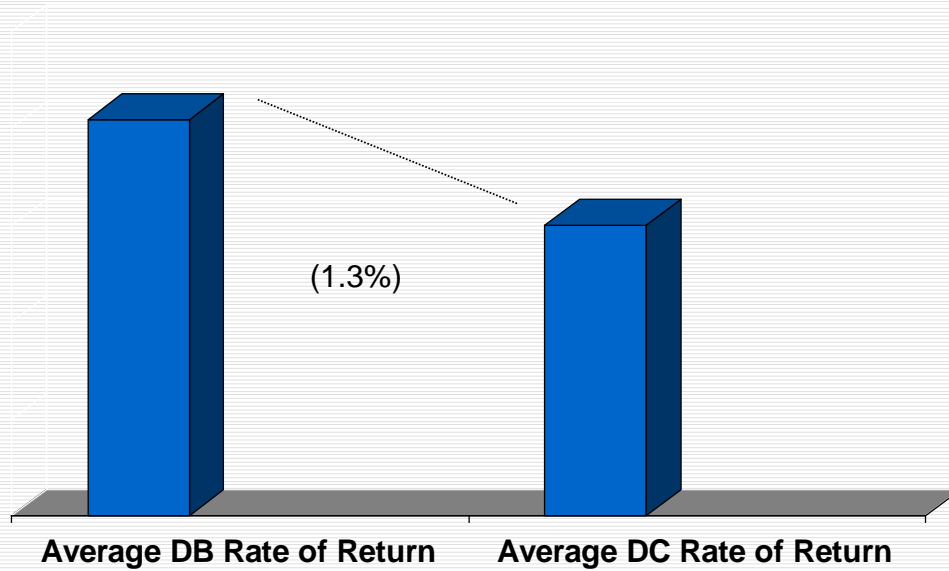
Jonathan Barry Forman & Yung-Ping [Bing] Chen, *Optimal Retirement Age*, in *New York University Review of Employee Benefits and Compensation—2008*, Volume II, Chapter 14 (2008).

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Pertinent here, Americans are living longer but retiring earlier.¹² In fact, we have all come to expect longer lives and long and leisurely retirements.

¹² For example, the life expectancy for a male born in 2007 was 75.2 years, up from just 61.4 years in 1940, and the average life expectancy for a 65-year-old male in 2007 was 16.7 years, up from just 11.9 years in 1940.

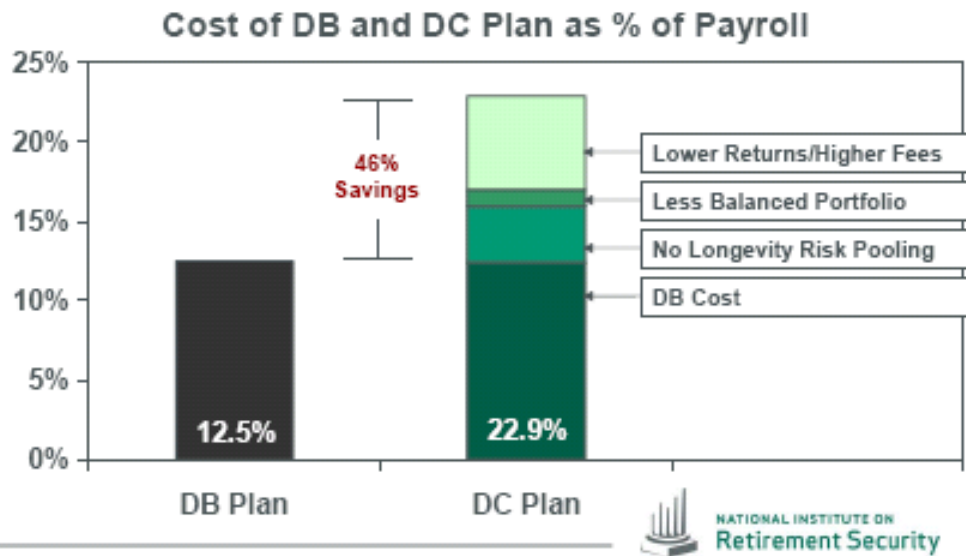
DB Annual Rates of Return outpace DC Plans 1995-2002



Retirement Services Roundtable analysis of Watson Wyatt data

Clearly, we need to redesign public pensions to encourage public employees to work longer and save more for their eventual retirements. But Frederick and Juliet's suggestion that we should replace the current system with a defined contribution system goes too far.

DB Plan Can Deliver Same Benefit at About Half the Cost of DC Plan



Beth Almeida & William B. Forna, *A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Plans* (National Institute on Retirement Security 2008), at 6.

Defined contribution plans are simply poor retirement savings vehicles. In general, individuals are lousy investors. They either invest too conservatively or take too much risk. Individual investors also pay higher fees than large public pension plans.¹³ And while traditional pensions pay benefits out as lifetime annuities, defined contribution plans typically make lump sum distributions that are all too quickly spent.

¹³ See, e.g., Jonathan Barry Forman, *The Future of 401(k) Plan Fees*, in *NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND COMPENSATION—2007*, Volume I, Chapter 9, pp. 9-1 to 9-18 (Alvin D. Lurie ed., 2007); Beth Almeida & William B. Forna, *A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Plans* (National Institute on Retirement Security 2008).

A Simple Cash Balance Plan

- For example, a simple cash balance plan might
 - allocate 10% of salary to each worker's account each year
 - and credit the account with 7% interest on the balance in the account
 - Under such a plan, a worker who earned \$30,000 in a given year would get an annual cash balance credit of \$3,000
 - $\$3,000 = 10\% \times \$30,000$
 - Plus an interest credit of 7% of the balance in her hypothetical account
-

Instead, I believe that the optimal pension plan for new workers is a cash balance plan.¹⁴

Under a simple cash balance plan, workers get allocations to hypothetical individual accounts every year just like in a defined contribution plan. But the assets are pooled and managed by professional investors. And benefits are paid out in the form of lifetime annuities.

¹⁴ See also Janet S. Hansen, Teacher Pensions: A Background Paper (Committee for Economic Development, 2008), http://www.ced.org/images/library/reports/education/report_educ200806pensions.pdf.

III. ACTUARIAL REVIEW OF PENSION LEGISLATION

Finally, I want to mention one way that legislatures can achieve some measure of fiscal self-discipline in the short term. In 2006, Oklahoma followed the Georgia approach and enacted actuarial limits on pension benefit increases.¹⁵ Under this approach, retirement bills with a fiscal impact can only be introduced in the first legislative session after an election and can only be approved in the second year.

After the actuarial review, no amendments that increase the cost can be made. If no specific provision is made to fund the legislation the bill is automatically repealed. And Georgia goes even further: the state must maintain minimum funding standards for its pension plans and each year must contribute the pension plan's normal cost plus the amount needed to amortize the unfunded liability.

¹⁵ Oklahoma Pension Legislation Actuarial Analysis Act ("Georgia" bill) (Senate Bill 1894). The bill applies to OPERS, the Judicial Retirement System and the Teachers Retirement System. The bill has three (3) prominent features. All retirement bills with fiscal impact must be introduced in odd years and voted on in even-numbered years. This can be bypassed for an "emergency" bill by a $\frac{3}{4}$ vote of each house. Each such bill must be analyzed for actuarial fiscal impact by a "Legislative Actuary." The actuary is hired by the Legislative Service Bureau. Finally, any retirement bill with fiscal impact must contain adequate funding either through a lump-sum appropriation or an increase in contributions sufficient to pay the cost of the change. The bill permits the Legislature to grant Cost of Living Adjustments (COLAs) without following the restrictions in the bill. COLAs can be given by the Legislature as long as they do not exceed the actuarial assumption of the System. OPERS assumes it will pay a 2% COLA each year for actuarial purposes. Oklahoma Public Employees Retirement System, *Legislation*, <http://www.opers.ok.gov/legislation>. See also Ronald K. Snell, *Pension and Retirement Plan Enactments in 2007 State Legislatures* (National Conference on Public Employee Retirement Systems, October 2007), <http://www.ncsl.org/programs/fiscal/pensun07.htm>.

IV. CONCLUSION

Ultimately, both papers on this panel are about the underfunding of public pensions and the moronic overpromising of benefits by our state legislatures. Thanks to the Government Accounting Standards Board, the jig is up. Government entities now have to report how well they are funding their pension obligations. And the bond ratings agencies are also beginning to exert significant pressure on states by downgrading the bonds of those states that have significant long-term pensions and benefit liabilities. Real pension reform will have to come soon.