Public Money

Sharing the Pension Pain

It's time for employees to buck up.

By Girard Miller | March 19, 2009

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"Pension Bills to Surge Nationwide"
— *Wall Street Journal*, March 16, 2009

With stocks losing half of their value since the market peak and pension funds losing 30 percent of their total portfolio value as a result, the costs to pay the pension promise will skyrocket in coming years. Public employees have suffered far less from the market meltdown than their private-sector counterparts because they belong to defined-benefit pension systems that guarantee them a fixed lifetime income. Unlike the taxpayers whose 401(k) accounts have become "201(k)" accounts, government retirees are largely unaffected by the bear market. They may have lost some value in their supplemental deferred-compensation (457) account, but that is usually pin-money compared with their pension.

The problem now is that the pension funds, which guarantee the income of public employees, have lost a half-trillion dollars in the meltdown. They are now about $1 trillion underfunded. Printed ea a *Wall Street Journal* story that headlines the mounting public pen crisis, the chart below shows one respected research group's esti projected funding ratios.

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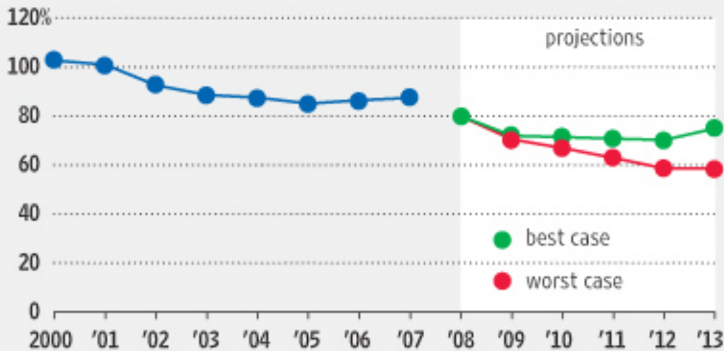
I think they may be too optimistic. Given that the national average funding ratio was 85 percent before the market melted, the recent 50 percent stock market losses on the 60 percent of their portfolios invested in equities should mean that their real-time funding ratios have already declined to a level closer to 60 percent today, while their liabilities continue to increase as employees age. The worst case could be worse if liabilities outrun assets.



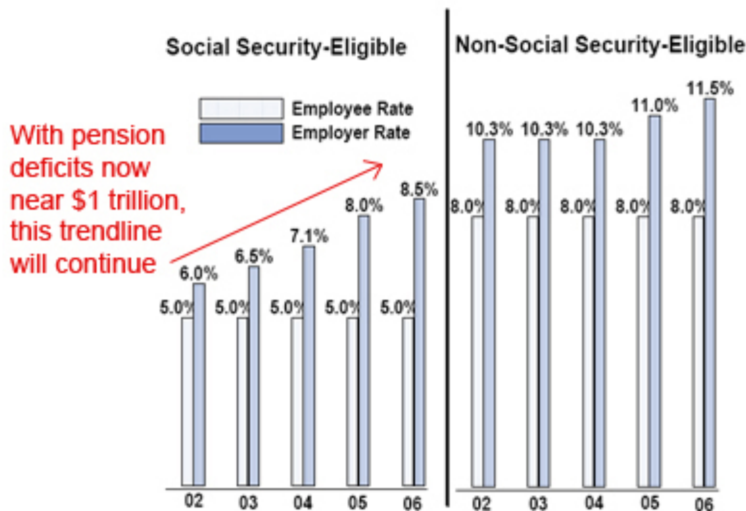
Facing these losses, pension plans are about to start sending eye-popping bills to state and local government employers. Nationally, the additional cost to amortize the losses of the past 18 months will ultimately be an annual increase in pension costs of approximately 2 percent of the value of the entire investment portfolio — or about $40 billion annually — unless stock markets rapidly recover at rates above the average actuarial assumption for equity returns.

Translated into payroll terms, that means a cost hike of 3 to 5 percent of total payroll, and there is increased chatter suggesting 20 to 50 percent increases in employer contribution rates. Actuarial smoothing may postpone the bills, but you can be sure they will eventually arrive.

Unfortunately, this is just a continuation of a disturbing trend. As the next chart below shows, the costs of running public pension plans have increased steadily. Even before the market started melting in late 2007, employers' costs increased 40 percent over a five-year period. Meanwhile, employee contributions remained constant. Figuratively speaking, they received a "straddle option" that gave them the "call" benefits of increased pensions when stocks went up, and the "put" protection of no cost increases when stocks went down. That's a mounting problem, and it begs for a change in course before employer costs double over the ten-year period that will end in 2012.

The Legacy of the Public-Pension Straddle Option:
Skyrocketing Employer Costs

Median Contribution Rates, FY 01 to FY 06



Employer costs increased 40% and employee costs remained constant.
Heads, employees win; tails, taxpayers lose.

Graphic: NASRA Public Funds Survey 2007

Note: Red commentary above by Girard Miller is his opinion only. It is not representative of NASRA or its staff.

From "gain-sharing" to "pain-sharing." Public officials have been slow to react to the changing landscape in pension finance, and it's imperative that they wake up and smell the coffee soon, especially those who are involved in labor negotiations. The rising costs of pension funding will force public employers to cut other benefits and reduce services, unless they act now to require employees to share in some of the price of having a guaranteed pension benefit. This is now a world in which everybody else is forced to work longer because their retirement savings were lost in the markets.

The political wolves are back at the door of public pension plans, the *Journal*'s recent story reported. Lobbyists will continue to promote defined contribution plan legislation — ostensibly in an effort to curb future costs. What the libertarians and investment houses fail to admit, however, is that a 401(k) type "solution" will do nothing to defray the costs of previous service credits or to pay off unfunded liabilities. A better solution is to preserve the basic benefits of pension plans by reforming them. In a future column I will address this theme more comprehensively, but for today's analysis, let's just focus on the single most important pension reform that would permanently address today's colossal underfunding problems: splitting the tab.

A decade ago, public employee unions lobbied for "gain-sharing" in which they got a share of governmental revenues or surplus investment returns. Very few governments actually established such systems, but those who did should now be demanding "pain-sharing" arrangements. Others may have no choice but to pursue the same course, because they naïvely granted de facto 'gain-sharing' deals through permanent and irreversible benefit increases when stocks peaked in 2000. Now they must achieve equilibrium through higher contributions.

Some of that extra money should come from employees, if these systems are to retain their benefits structures. And others may conclude that for long-term policy reasons as outlined below, it is now appropriate to require or bargain for public employees to pay a fair share of the costs to dig out of the hole we've collectively dug.

An ideal, properly balanced solution for most employers would be to require or bargain for their employees to pay one-half of the increased costs of pension benefits that resulted from the market meltdown. In some cases, this will take several years to accomplish, because of actuarial smoothing. In some cases, the increase in payroll withholding may be too abrupt for employees to absorb if their salaries have been frozen, and it might take a few years to ramp up their contributions. But the end-game should be a rebalancing of the data on the bar chart shown above so that public employees pay roughly one-half of the increased costs of their pensions, if not half of the total annual contributions.

A corollary remedy for retirement medical benefits plans is to split the actuarial cost equally between employers and employees. Given the mounting magnitude of the OPEB underfunding (retiree health care), the primacy of pension benefits, and tight budgets everywhere, this may also require several years to ramp up, for both employers and employees.

This cost-sharing approach will achieve several important objectives, some of which are in the employees' best long-term interests as public plans draw increased scrutiny and negative press:

- Public employers will not have to lay off employees or cut other benefits in order to pay the entire costs of more-expensive pensions.

- Most public employees would prefer to pay an increased contribution than to have their pensions or other benefits reduced in the future. Labor negotiators tell me this frequently.

- Employees become full partners in the pension system, rather than free-loaders. (Actually, public employees have generally been junior contributing partners in to their pension plans, so the free-loader stigma is undeserved, but an equal partnership eliminates that complaint.)

- Taxpayer critics and the media can be shown that employees share equally in the pain of cost increases, right along with the public.

- If financial markets recover and plans become overfunded in the future, it will be more appropriate to jointly reduce employer and employee contribution rates rather than to make permanent, constitutionally protected and irreversible benefits increases.

- There will be less pressure from retirees for benefit increases in the future if active employees bear half of the costs. The concept of intergenerational equity takes on new meaning when it's one employee paying for another, and not an invisible taxpayer.

For retirees, the Grinch-ly alternatives. There is no easy way to impose a similar cost on retirees through most pension systems. There are constitutional and statutory protections. However, some taxpayer advocates would argue that protected-pensioners should likewise be expected to absorb some fair share of the burden for extreme market losses in the pension funds — from which retirees have been 100 percent sheltered.

One approach is to defer future cost of living (COLA) increases until such time as the pension plan returns to normal funding ratios and its 10-year investment performance exceeds the actuarial assumptions. If salaries are frozen, in the worst economic crisis in 80 years, shouldn't pensions be as well?

Another policy alternative is to require a percentage of the pension to be returned to the employer as a co-payment toward the retiree's medical benefits, which are not constitutionally protected. This cost-sharing provision could be made conditional on times when the employer's pension costs have risen by X percent, or when the pension plan is Y percent underfunded. Alternatively, a hard-dollar cap on retiree medical benefits would accomplish a similar objective.

Some employers will reject these remedies for a variety of reasons including legal or "social contract" issues or fears of media characterizations of being the "pension-Grinch." For public employers whose only alternative is to lay off workers, some pain-sharing with retirees may be unavoidable. And for many state and municipal governments, the only balanced approach is for sacrifices to be shared by all: employers, taxpayers, employees and retirees.

A trap to avoid. Governmental labor negotiators are now getting pitches (from very savvy union stewards) to pay for employees' pension contributions in lieu of salary increases. That is probably the dumbest idea on this planet, in case you haven't figured it out by now. After reading this column, any public official who encounters such a preposterous proposal should call an immediate time out, e-mail me and demand a better solution to your problems. That kind of policy is heading in exactly the wrong direction!

The playing field has truly changed. For many years, the justification for public pension benefits was that they provided catch-up compensation for employees who received lower salaries. As private-sector workers have lost their pension benefits, and average salaries have stagnated in the private sector amid rising unemployment, that rationale has lost its authenticity. Making public employees equal partners on the contributions side of the ledger will go a long way to making public plans genuinely sustainable.

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