Making Pensions Work for Public Servants and for Taxpayers

July 02, 2014

By Dick Clark

Detroit, Michigan has become notorious for its rapid decline over recent years. Although most luridly illustrated by the rows of vacant houses that are gradually being reclaimed by nature,[1] this decline was made even more painfully apparent by the city's bankruptcy declaration last year.[2] With a pension deficit approaching $4 billion, total pension and retiree healthcare liabilities comprise half of the $18 billion in municipal debts identified in the city's bankruptcy filing last summer.[3] Although few local governments face the manifold challenges currently seen in Detroit, major cities and more than half a dozen states across the country have recently revisited their public pension systems to avoid the systemic risk that unsound retirement plans can create.[4]

These changes are not just based on unrealized concerns about future events. Public employee pensions are already posing an increasing budgetary burden for state and local governments. Annual employer contributions from state and local governments to pension plans more than doubled from 2002 to 2011, reaching $84 billion.[5] Nebraska is not free from the budgetary pressure exerted by public pensions, with annual required contributions to the state's cash balance plan rising from just over $14 million in 2003 to over $56 million in 2013.[6] The mounting pressure from pensions is largely attributable to program designs that cost more than those commonly used by private employers, combined with public employers' failure to faithfully make contributions adequate to cover the future benefits that they promise.[7]

Typical private sector retirement plans cost employers approximately 3 percent of wages, representing the amount that they contribute to pension accounts for their employees. For comparison, the Omaha Police and Firefighters Retirement System (OPFRS) has a "normal cost" of 23 percent of payroll, or 6 percent of wages after factoring out employee contributions. The Nebraska Public Employees Retirement System (NPERS) has a normal cost of 10.4 percent of payroll, still nearly double the private market cost even after subtracting employee contributions.[8]

In addition to these elevated normal costs, the unsound Defined Benefit plan designs utilized in these pension systems impose still further costs on taxpayers. These designs assume unrealistically high predicted rates of return on plan investments, with OPFRS, school, judicial, and state law enforcement plans assuming 8 percent annual returns. By comparison, Warren Buffett's Berkshire Hathaway assumes only 6 percent returns for its pension plan.[9] Building plans around unreasonably high return predictions may mean taking significant risks in managing invested funds.

Alternatively, pension promises based on overly optimistic estimates of market returns means that shortfalls in investment performance must be made up through increased employer contributions to cover unfunded liabilities from previous periods. The resulting amortization payment for the Omaha Police and Fire fund is almost 39 percent of payroll, a substantial boost in employer costs over normal payroll requirements. Because of the size of this payment, the City of Omaha is not making the full payments necessary to cover this future liability. The latest actuarial report shows that contributions are short by about 11 percent of pay, totaling approximately $13 million over the $39 million already contributed by the city.[10] Omaha has not fully paid its actuarially required contribution (ARC) since 2002, and in 2012, the city paid only 62 percent of its ARC.[11]

This failure to adequately provide for the promised benefits means even higher contributions rates in the future, a burden that will have to be shouldered by taxpayers. Underfunded pension obligations also increase the cost of borrowing for the city. They were cited as the principal reason for a downgrade of Omaha's bond rating by Moody's in 2012, referencing a "persistent under-funding of its pension obligations which is not consistent with the expected financial practices of highly rated cities."[12] Similar concerns were described by Standard & Poor's when that service downgraded its rating of the city's creditworthiness in 2013.[13] Omaha's unfunded pension liabilities — with a fair market valuation of more than $1.4 billion[14] — could also jeopardize the provision of basic public services, as pension costs grow as a percentage of the budget and take priority over other government expenditures.

Despite the substantial expense imposed by these plans, there is good reason to believe that they are actually less than competitive in terms of attracting and retaining a high-quality workforce. Defined Benefit plans are "backloaded" and richly reward long-term employees while mostly passing over new employees.[15] Defined Contribution plans are far more portable than traditional Defined Benefit plans, and they offer more meaningful benefits to modern American workers, who tend to be much more geographically and economically mobile than foreign workers or even American workers from previous generations.[16]

The traditional Defined Benefit plans currently in use present three basic categories of problems: cost, risk, and labor supply incentives.[17] While the cash balance plan currently in use by NPERS solves the labor supply problem by smoothing benefits accrual, as a type of Defined Benefit plan it still faces cost and risk challenges that could be resolved by moving to a Defined Contribution retirement plan. Policymakers in Omaha, Lincoln, and throughout Nebraska should consider reforming public pensions, with a view to moving to a true Defined Contribution plan that incorporates recognized best practices including automatic enrollment, reasonable default contribution rates, life-cycle portfolio design, and utilization of low-cost index funds. Moving to a Defined Contribution plan for public employees will enhance the retirement security of public employees and would provide a useful check on the temptation of public employers to skimp on meeting retirement obligations.[18] Given the tremendous budgetary pressures that reform would relieve, taxpayers would not have to wait long to see the benefits of a more honest public employee retirement system. With unfunded pension liabilities approaching a billion and a half dollars in Omaha alone, the city may be a lot closer to Detroit than taxpayers and public officials realize.

To learn more about the Omaha public pension situation, read the new Platte Institute policy study: "Protecting Omaha's Future: Confronting the Challenge of Public Pension Reform".

---

[1] Feinberg, Ashley. "Tracking Detroit's Decay Through Google Street View." Gizmodo.June 5, 2014. [URL: http://gizmodo.com/tracking-detroits-decay-through-google-street-view-1586631393]

[2] Mildenberg, David. "Detroit Bankruptcy Prods Cities to Target Pensions: Muni Credit." Bloomberg. February 28, 2014. [http://www.bloomberg.com/news/2014-02-28/detroit-bankruptcy-prods-cities-to-target-pensions-muni-credit.html]

[3] *Ibid.*

[4] *Ibid.*

[5] Biggs, Andrew. "Protecting Omaha's Future: Confronting the Challenge of Public Pension Reform." Policy Study. Platte Institute for Economic Research. June 2014. p. 3.

[6] *Ibid.*

[7] *Ibid.*, p. 4.

[8] *Ibid.*

[9] *Ibid.*

[10] *Ibid.*, p. 5.

[11] *Ibid.*, p. 7.

[12] "Rating Action: Moody's downgrades City of Omaha's (NE) GOULT rating to Aa1 from Aaa; Outlook remains stable." Global Credit Research. Moody's Investors Service. September 21, 2012. [URL: https://www.moodys.com/research/Moodys-downgrades-the-City-of-Omahas-NE-GOULT-rating-to--PR_255890]

[13] Golden, Erin. "City of Omaha's bond rating downgraded; pension concerns cited." *Omaha World-Herald*. September 12, 2013. [URL: http://www.omaha.com/news/city-of-omaha-s-bond-rating-downgraded-pension-concerns-cited/article_c01e0f57-9f7d-552e-aa0e-3d8fb7c44785.html]

[14]Biggs, Andrew. “Honest Accounting and Public Employee Pensions in Nebraska.” Policy Study. Platte Institute for Economic Research. May 2013. p. 10. [URL: http://www.platteinstitute.org/Library/docLib/20130520_Platte-Pension_(3).pdf]

[15] *Ibid.*, pp. 8–9.

[16] “Internal mobility: The United States” Country Benchmarks. World Bank. 2011. [URL: http://siteresources.worldbank.org/ECAEXT/Resources/258598-1284061150155/7383639-1323888814015/8319788-1324485944855/10_us.pdf]

[17] Biggs 2014, p. 10.

[18] *Ibid.*, pp. 16–17.