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MISSOURI'S CHALLENGE: MANAGING LONG-TERM EMPLOYEE BENEFIT COSTS

Missouri's three major public pension plans provide retirement benefits to approximately 86,000 retirees and beneficiaries, and 180,000 active public employees. While those figures represent only a fraction of Missouri's workforce, all of the state's taxpayers shoulder the employer costs of the program. Considering the volatile economic climate, and an aging workforce, the state must reform the public pension system or face severe funding problems in the foreseeable future.

The full study by Richard C. Dreyfuss, "Missouri's Challenge: Managing Long-Term Employee Benefit Costs," analyzes the state's largest public pension plans and identifies the long-term fiscal challenges facing the pension system as a whole, absent any reform. Additionally, the study references benefit practices in the private sector — i.e., the pension plans of many of Missouri's largest private employers — as a benchmark to evaluate market competitiveness and the fiscal health of the three public plans.

BACKGROUND ON RETIREMENT BENEFITS

In Missouri, the principal type of public retirement plan is provided through a defined-benefit pension — which involves regular payments made to a retiree established by a formula — and possibly other post-employment benefits, such as health care. Historically, pension systems represented the majority of retirement benefit spending, but the rising cost of health care has required more and more spending on health insurance for retirees.

Pensions are usually funded through ongoing contributions that an employer and/or employee makes into a trust fund devoted to long-term investments (for a more thorough introduction to pension funding, see Appendix A of the full study). These assets accumulate over time, and are subject to year-to-year fluctuations. The funding practices that should be structured involve employees' pensions

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being fully “paid up” at their retirement dates. This avoids the problem of costs being transferred to future employees and taxpayers.

An employer can promise either to deposit a set amount into an investment account (defined contribution plan) or else guarantee how much the plan will pay out at retirement (defined benefit plan). While the costs of defined contribution plans are easily calculated and predictable over time, the costs of defined benefit plans change from year to year and can fluctuate significantly, given that they are based upon actual experience and future estimates.

Missouri's public pension system has approximately 120 pension plans (approximately 86 of which are defined benefit plans), the three largest being the Missouri State Employees Retirement System (MOSERS), Public School Retirement System of Missouri (PSRS), and Public Education Employee Retirement System of Missouri (PEERS). The provisions of these plans are summarized and compared in Appendix B of the full study.

Other post-employment benefit (OPEB) liabilities are computed separately from pensions. These costs were previously reported on a pay-as-you-go basis, but new accounting requirements specify that they must now be determined in a manner similar to defined benefit pension plans. This will impact entities such as the Missouri Consolidated Health Care Plan (MCHCP), which insures a significant portion of public sector retirees throughout the state. In addition, cities, local school districts and other entities that provide retiree health care will face the challenge of

determining and paying for the costs of their current and future retirees.

PLANNING FOR RETIREMENT (SYSTEMS)

The ideal retirement program is one that provides competitive benefits at an affordable cost. This balance requires the long-term costs to the employer and the future benefits for the employee to be as predictable as possible, allowing both parties to plan accordingly. If a retirement plan's costs are predictable, an employer can more easily determine how much money should be set aside leading up to an employee's retirement. Essentially, a healthy retirement program has a “CAP”: based on costs that are Current, Affordable, and Predictable.

Current: To determine whether a plan is on target to pay future benefits, those benefits must first be valued annually. Five principal factors determine the amount of a defined benefit employer liability: 1) any required contributions by the employee; 2) the benefit formula's annual multiplier; 3) the definition of earnings that will be included; 4) any reductions for early retirement; and, 5) any retiree cost-of-living adjustment.

This annual valuation process involves determining the value of plan assets, and comparing this to the value of liabilities earned to date, resulting in a funded ratio. If a plan's funded ratio is less than 100 percent, the difference that must be made up is termed an “unfunded liability.” Thus, in order to keep the plans current, employee and employer contributions are determined and adjusted to make up the difference



(although state law limits the amount of annual adjustments for some of the plans). A pension fund with a funded ratio of 100 percent is not “paid in full,” it is only “up to date” (at least for the current year).

The plan year for the state’s three largest pension plans ends on June 30. As of June 30, 2007 (most recent figures available), Missouri’s three largest public pension systems had funded ratios between 83 percent and 87 percent, and combined unfunded liabilities of nearly \$7 billion.

Affordable: By repeatedly failing to remain current, the state’s public pension system runs a risk of deferring such liabilities, which raises affordability issues. A related question is: Who will assume the funding obligation of these costs, and when will this occur? The state’s workforce is aging, and as baby boomers retire, they will no longer contribute to the fund. The average age of workers eligible to receive benefits from the three primary pension plans discussed is between 42 and 47 — an average of 13 to 18 years until retirement, depending on the plan (see full study’s Table 1).

Of note, these plans maintain a moving (or “open”) 30-year amortization schedule, meaning that any unfunded liability is annually reset. While increased contributions and favorable investment earnings will reduce this liability, such liabilities are unlikely to be fully funded in the foreseeable future.

The goal should be to achieve annual employer pension costs in the range of 5 percent to 7 percent of payroll. Such a standard is common among some defined benefit pension plans, and is typically seen in defined contribution plans.

As these pension systems currently stand, unless investments realize earnings

in excess of the annual assumption of 8 percent to 8.5 percent, younger employees will have to increase their level of contributions considerably, and the remainder of the public pension costs will be passed on to the taxpayers. Clearly, this is not a desirable option.

Predictable: Pension contributions can be difficult to predict, given the inherent uncertainty of many calculation variables. While certain averaging and other smooth techniques can be used, these often create tradeoffs involving the other two factors of affordability and keeping funding current. The inability to manage all three factors together has resulted in the increasing popularity of defined contribution plans.

Retiree Health Care Costs: The Government Accounting Standards Board (GASB) sets forth rules and guidelines for the proper financial reporting involving public entities. Until recently, the costs of non-pension retirement benefits (other post-employment benefits) were recognized on a pay-as-you-go basis, meaning that only the contributions and expenditures paid in the current year were accounted for.

GASB Statement 45 (GASB 45) now requires other post-employment benefit programs to account and report accrued liabilities in a manner similar to that used for pensions. Given that very few retiree medical plans were previously prefunded, the result is that a significant amount of unfunded accumulated liability must now appear on financial statements. GASB 45 only dictates how the liability is accounted for and reported; there is no actual requirement to fund those liabilities. Yet, as these substantial unfunded liabilities are reported for the first time, policymakers and taxpayers will demand

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that a strategy must be adopted to manage these liabilities effectively.

BENCHMARKING: PUBLIC VS. PRIVATE

Retirement benefits are an important part of an employment package used, in many cases, to compete with the private sector for employees. Government should certainly remain competitive with market practices, but an analysis of the cost of public pension plans should also consider whether those costs are reasonable. One of the best measures (benchmarks) of reasonability is to evaluate private-sector practices.

Survey results for Missouri's largest private employers indicate that public pension benefits are more generous than private pensions, but the costs are also higher. Such a differential needs to be reconciled with the total pay and benefit program, and also with the taxpayers' ability to pay.

Private-employer data for Missouri and national trends both show a clear shift away from final pay plans to either: (1) other types of defined benefit plans (such as hybrid plans), which are largely determined by career earnings; or, (2) defined contribution plans. Both strategies are intended to provide competitive benefits while achieving current, affordable, and more predictable cost patterns.

REFORM

The Federal Pension Protection Act of 2006 requires private pension plans to achieve a 100-percent funded ratio over a seven-year period, and sets uniform standards for estimating long-term costs (therefore, "100 percent funded" carries the

same meaning across all private pension plans). The federal government justifies regulating these private-sector benefits in part because of the risk of potentially assuming any unfunded liabilities.

The risk in public sector plans is borne by a combination of higher employee and taxpayer contributions. For example, compared to the public pension practice of using an "open" 30-year amortization window (previously discussed), private pensions are limited to seven years. Many public pension advocates believe that a funded ratio of only 80 percent is acceptable. They reason that government will always exist, and there will always be taxpayers, so there will always be someone to pay for future benefits.

CONCLUSION

Retirement plans should be designed to achieve affordable and predictable costs while ensuring that these costs are kept current. These goals explain both the national trend and Missouri's private-sector preference leaning toward a defined contribution pension structure, given that many defined benefit plans struggle to achieve just one of these criteria.

In addition, the level of retiree medical benefit liability that exists throughout the state must be quantified, aggregated, and effectively managed. One can witness everyday instances in the private sector of attempts to effectively manage these costs to affordable levels. Such costs must logically be managed in the public sector, as well, consistent with the taxpayers' ability to pay.

For more details, please see Show-Me Policy Study no. 16, which is available at www.showmeinstitute.org.



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