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MISSOURI TRANSITION COSTS AND PUBLIC PENSION REFORM

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INTRODUCTION

The goal of public employee pensions is twofold: to provide a safe and secure retirement for our valued state employees and to help recruit and retain talented individuals into public service careers. Unfortunately, many of Missouri's public employee pension systems have flaws that make it difficult to achieve either of these tasks.¹ Moreover, these pension plans put taxpayers on the hook if and when they become unfunded. The Show-Me Institute consistently points to the flaws in these systems and has recommended that the state transition to plans that are structured in a more effective and efficient manner. This would require closing some of our current pension plans.

Some opponents of this idea worry that closing our current plans would not save the state money; rather, they say it would be more risky and would result in high transition costs. This is the topic addressed in our policy study "Missouri Transition Costs and Public Pension Reform," by Andrew Biggs, Ph.D., resident scholar at the American Enterprise Institute.

WHAT ARE THE PROBLEMS WITH MISSOURI'S CURRENT PENSION PLANS?

The problems with Missouri's current pension plans are myriad. Here, we highlight just a few.

Unfunded Liabilities – In a 2013 policy study for the Show-Me Institute ("Public Employee Pensions In Missouri: A Looming Crisis"), Biggs examined the

unfunded liabilities of Missouri's five largest public employee pension systems.² Unfunded liabilities are the difference between a pension system's obligations to current and future retirees and the pension system's assets. Calculations of this nature depend on assumptions. Most of Missouri's pension plans assume an 8 percent return on their investment, otherwise known as the discount rate. Biggs, and most economists, argue that unfunded liabilities should be calculated using a *risk-free* discount rate of 4 percent. Regardless of which rate you use, it is clear that Missouri's five largest pension systems have substantial unfunded liabilities.

Using the discount rates that the plan sponsors list, the total unfunded liabilities are more than \$11.1 billion. If we assume the *risk-free* discount rate, the unfunded liabilities swell to more than \$53.9 billion. If left unchecked, unfunded pension liabilities may continue to rise and Missouri taxpayers will be on the hook.

The Pull/Push – Many of Missouri's pension plans are designed with a dramatic increase in pension wealth at the point of retirement. As a worker approaches retirement, his or her pension wealth spikes tremendously. After the retirement point, his or her total pension wealth declines. This is illustrated poignantly in Figure 1.³ This figure illustrates the total pension wealth of a Missouri teacher in the Public School Retirement System (PSRS). As the teacher approaches retirement, they are *pulled* to stay in the profession because of the large benefits they will receive if they work the additional years.

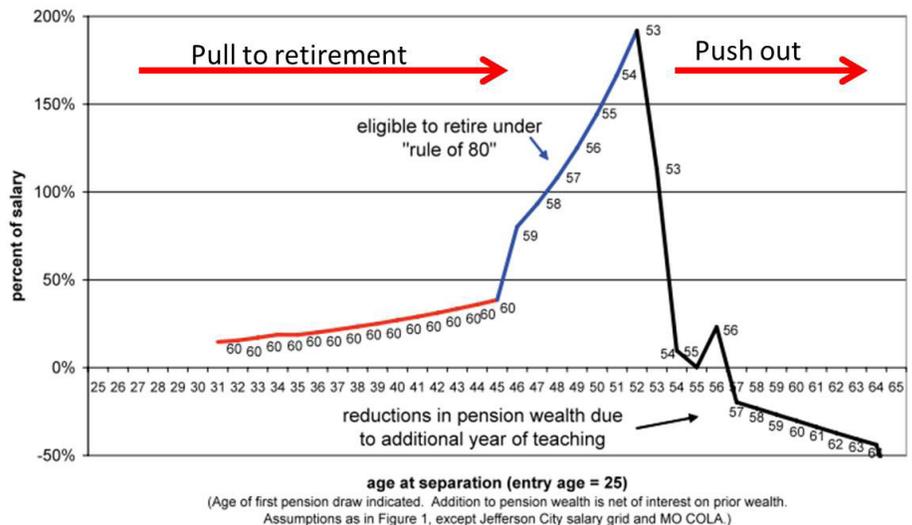
Economists Robert Costrell and Mike Podgursky call this pull to stay in the pension system “Golden Handcuffs.”⁴ Teachers, and other employees in similar systems, are enticed to stay in their current pension system even if they might wish to move to a different career. This may be beneficial for retaining employees, but could give rise to retaining the wrong type of employees. That is, if an individual wants out of a public service career, such as teaching, enticing them to stay may not actually benefit the public.

After public employees reach the spike in pension wealth, their total wealth accrual turns negative. They start losing pension wealth for each additional year they work because they will be able to collect for one less year. This serves to push individuals out of the profession. Once again, this is not the optimal way to retain quality individuals in public service jobs. The pull/push effect distorts the labor market.

Lack of Reciprocity – As we have noted, most pension systems are designed in ways that distort the labor market by enticing workers to stay in a given pension system and then pushing them out after they reach the optimal retirement age. Most of these systems also lack reciprocity. That is, when you leave one system before the retirement age and move to another system, you cannot take your eligible years of service with you. As we see in Figure 1, if a worker does not stay in the system long enough, he or she will not hit the spike in pension wealth. By splitting time between two systems, a worker can be expected to have a greatly reduced pension.

This lack of reciprocity is particularly troubling in education because the state has three separate teacher pension systems – Kansas City, Saint Louis, and the rest of the state (PSRS). Research has documented that these pension boundaries limit the pool of school leaders willing to work in Saint Louis and Kansas City.⁶ In PSRS, just 54 percent of school leaders are hired from within a school district. In the cities, that figure climbs to more than 90 percent. The end result is lower-quality school leaders, on average, in our state’s two urban centers.

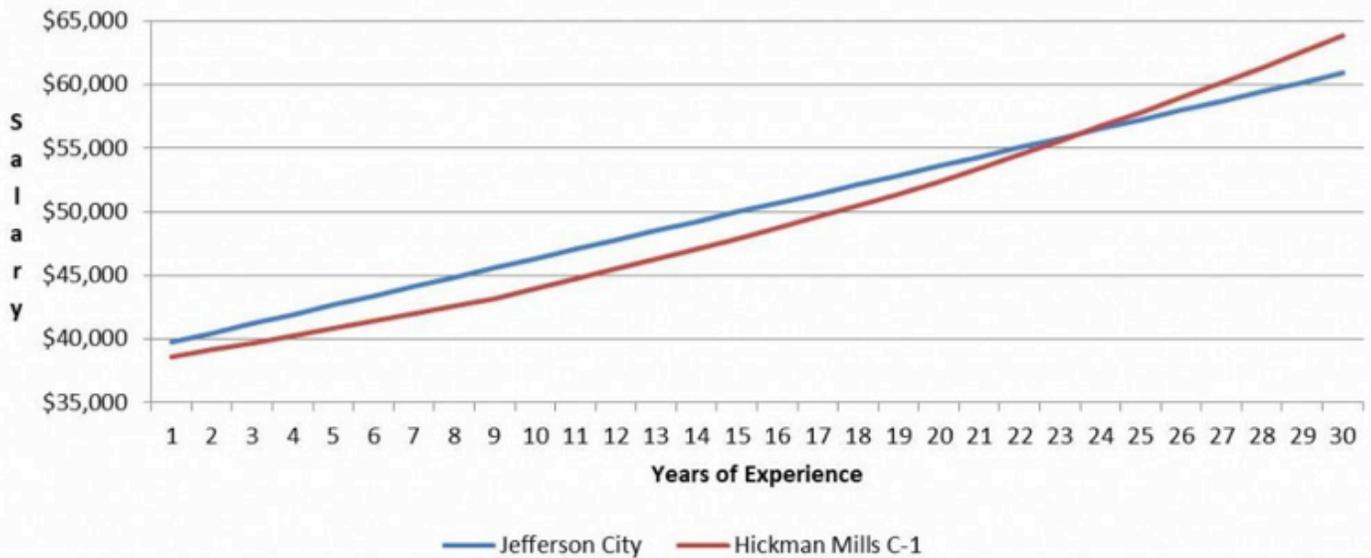
FIGURE 1: Deferred Income Per Year, As Percent Of Salary: Missouri Addition To Pension Wealth From An Additional Year Of Teaching⁵



Gaming and Manipulation of Benefits – Pension plans are often calculated based on a *final average salary*. Unlike Social Security, which is based on an individual’s lifetime earnings, most of Missouri’s public employee pension plans only take into account a few years of employment. For instance, PSRS bases final average salary off of an individual’s three highest consecutive salaries. This type of calculation invites gaming and manipulation of pension benefits.

By moving to a higher-paying job within the same pension system, an individual can dramatically increase his or her pension wealth. For example, at the end of his or her career, a superintendent can switch to a new district for a short-term job at a considerably higher salary. This is just what Terry Adams did when he switched from the Wentzville School District to the Rockwood School District. As the *St. Louis Post Dispatch* reported, “Because of the intricacies of Missouri’s educator pension system, his one-year spike in pay will net him an additional \$20,000 for each year of his retirement.”⁷ His gain is the pension system’s loss. It increases the liabilities of the pension system; a cost that other retirees or the taxpayer must fund.

This type of manipulation of the pension system can even occur when an individual does not change jobs. It is possible for public employee salaries to increase steeply as the worker approaches retirement.⁸ Take for example, the Jefferson City School District and the Hickman

FIGURE 2: Teacher Pay Based on 2012-13 Master's Degree Salary Schedules⁹

Mills School District (Figure 2). Over the course of his or her career, a Jefferson City teacher will pay more into the retirement system than a Hickman Mills teacher. Yet, he or she will earn less in retirement. This is because the Hickman Mills salary peaks at the end of a teacher's career, raising his or her final average salary.

These are just a few of the problems with Missouri's current public employee pension plans. The bottom line is that they distort the labor market, are subject to gaming and manipulation, and can lead to crippling unfunded liabilities. All of these problems stem from the fact that an individual's pension wealth accrual is not tied directly to his or her contributions.

WHAT IS THE SOLUTION TO MISSOURI'S PENSION PROBLEMS?

The solution is to align benefits to contributions. This can be accomplished by transitioning to better designed alternatives (e.g. defined contribution, hybrid defined contribution/defined benefit, cash balance, etc.). These plans would solve the problems outlined here and would be a better system for most public sector workers. The current plans primarily benefit workers who stay for 25 to 30 years in a given pension system at the expense of those who do not. In a study of the nation's 10 largest school district retirement plans, McGee and Winters noted that switching to a system with smooth wealth accrual would lead to many positive outcomes for workers.¹⁰ This change could potentially:

- Lead to increased upfront salaries.
- Provide greater retirement security.
- Make public service careers more attractive for individuals who may not want to stay for decades in one career.
- Provide greater control and flexibility for the individual to determine when they will stop working.

WOULD THERE BE SIGNIFICANT COSTS TO TRANSITION TO A NEW SYSTEM?

This is precisely the question asked in our latest paper by Andrew Biggs. He wrote, "One potential obstacle to such reforms are so-called 'transition costs,' which imply that shifting public employees from [defined benefit] to alternate pension plans would increase costs, substantially and for an extended period, before any savings are realized." Claims of significant transition costs fall into two camps: accounting-based transition costs and the "perceived need for closed [defined benefit] plans to shift to more liquid, less risky assets as its population ages." The former implies that rules and regulations may hinder such a transition while the latter suggests that the change in the plans' assets would lead to lower returns on investment. These claims have made it difficult to enact reform in Missouri and other states, but Biggs argues that these "claims of transition costs are at some times, overstated and, at other times, entirely mistaken."

He concluded:

There are both pros and cons to structural reforms of public plans, and any cash balance or defined contribution plans proposed for public employees should be carefully designed to provide adequate protections in a cost-efficient manner. But concerns about so-called transition costs are almost entirely mistaken and should not stand in the way of public employee pension reform.

WHAT IS THE KEY TAKEAWAY?

Perceived transition costs are nothing more than a red herring and should not impede efforts to transition Missouri's public employees to an improved pension system.

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NOTES

¹ Joint Committee on Public Employee Retirement. "2014 Annual Report to the Missouri General Assembly." 2014. View online here: <http://www.jcper.org/2014AnnualReport.pdf>.

² Biggs, Andrew. "Public Employee Pensions in Missouri: A Looming Crisis." Show-Me Institute Policy Study. March 11, 2013. View online here: <http://www.showmeinstitute.org/publications/policy-study/taxes/922-ps36-biggs-public-pensions.html>.

³ Costrell, Robert M., and Michael Podgursky. "Golden Handcuffs." *Education Next*. Winter 2010/Vol. 10, No. 1. View online here: <http://educationnext.org/golden-handcuffs/>.

⁴ Ibid.

⁵ Podgursky, Michael. "Market-Based Pay Reform for Public School Teachers." National Center on Performance Incentives Working Paper 2008-07. February 2008. View online here: https://my.vanderbilt.edu/performanceincentives/files/2012/10/200807_Podgursky_MarketBasedPay1.pdf.

⁶ Koedel, Cory, Jason A. Grissom, Shawn Ni, and Michael Podgursky. "Pension-Induced Rigidities in the Labor Market for School Leaders." National Center for Analysis of Longitudinal Data in Education Research Working Paper 62. October 2011. View online here: <http://www.caldercenter.org/upload/wp62.pdf>.

⁷ Bock, Jessica. "One-year superintendent job highlights questions about educator pensions." *St. Louis Post-Dispatch*. Oct. 7, 2013. View online here: http://www.stltoday.com/news/local/education/one-year-superintendent-job-highlights-questions-about-educator-pensions/article_676228f3-fc57-5273-8ef4-7d21e4b36272.html.

⁸ Shuls, James V. "Robbing Peter To Pay Paul's Defined Benefit Pension." *Education Next*. Oct. 23, 2013. View online here: <http://educationnext.org/robbing-peter-to-pay-paul%E2%80%99s-defined-benefit-pension/>.

⁹ Ibid.

¹⁰ McGee, Josh, and Marcus A. Winters. "Better Pay, Fairer Pensions: Reforming Teacher Compensation." Civic Report No. 79. September 2013.



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