

TESTIMONY

April 10, 2014

Missouri Public Pensions: Their Funding Status And Roadblocks To Reform

By Michael Rathbone

Testimony Before the Joint Committee on Public Employee Retirement

To the Honorable Members of the Committee:

Ladies and gentlemen, thank you for the opportunity to testify today. My name is Michael Rathbone and I am a policy researcher for the Show-Me Institute, a nonprofit, nonpartisan Missouri-based think tank that supports free-market solutions for state policy. The ideas presented here are my own. This testimony is intended to summarize research the Show-Me Institute has published that analyzes the financial state of Missouri public pensions and addresses some objections raised about shifting public pension plans to a more efficient structure.

The unfunded liabilities of the state's public pensions are an economic ticking time bomb. By using high discount rates, these pensions understate the amount of additional funding they need in order to be

financially secure. In a policy study written for the Show-Me Institute, Andrew Biggs, of the American Enterprise Institute, showed that if these public employee pensions use a more appropriate discount rate, they would more accurately assess the true size of the state's obligations, which taxpayers must end up fulfilling.¹

If pension liabilities continue to be understated, the state faces a significant risk and policymakers may be forced to make drastic cuts to services or significantly raise taxes in order to meet the state's pension obligations. The risk posed to Missouri's financial well-being is a real and serious one.

The state needs to better account for risk in order to start reforming public pensions. Taxpayers, state officials, and public employees all

Michael Rathbone is a policy researcher at the Show-Me Institute, which promotes market solutions for Missouri public policy.



ADVANCING LIBERTY WITH RESPONSIBILITY
BY PROMOTING MARKET SOLUTIONS
FOR MISSOURI PUBLIC POLICY

Nothing about this project should involve public assistance. The project is proposed for a desirable location that is already part of an economically vibrant area

have expressed concern about the financial health of Missouri's public pension plans for state employees. The funding health of these plans has declined in recent years and current annual required contributions have increased for all of the state's largest pensions.

Most Missouri public employees participate in one of five retirement plans:

- Missouri State Employees Retirement System (MOSERS)
- Highway and Transportation Employees' and Highway Patrol Retirement System (MPERS)
- Missouri Local Government Employees Retirement System (MOLAGERS)
- Public School Retirement System of Missouri (PSRS)
- Public Education Employee Retirement System of Missouri (PEERS)

Combined, these plans report unfunded liabilities as of 2013 of \$13.7 billion and a funding ratio of 77.4 percent.

However, this official amount vastly underestimates the true liability of these pensions. In Biggs' examination of these pension funds for plan year 2012, he found that the value of their unfunded liabilities was **five** times their officially reported amount.²

According to Biggs, these public pensions are allowed to use a discount rate to calculate the present value of their plans' liabilities that

is different from one that economic scholars such as Biggs and private sector plans use.³

A discount rate basically is compound interest in reverse. If, for instance, I owe someone \$10,000 five years from now, the discount rate tells me how much I would need to invest to ensure I can make that payment. The higher the rate of return, the lower amount I need to invest. Assuming I could get a robust 12 percent annual return on my money, I need to invest only \$3,200 to repay my loan. However, if I believe I would only get an annual 4 percent return on my money, I need to invest \$6,800.

The Missouri plans use discount rates between 7.25 and 8 percent. Most economists would use a lower rate, which better accounts for the risks inherent in a portfolio with risky assets and guaranteed liabilities.

Despite these five public pensions expecting returns between 7.25 and 8 percent on their portfolios, their actual returns can be much higher or much lower than expected. This volatility brings with it an added risk: a major down year can have an adverse impact on the portfolio's assets. If, for instance, the state pensions had a 10 percent loss one year and a 10 percent gain the next year, they would still have suffered a net loss.

There is nearly universal support among economists for using low discount rates to value public pension liabilities. In October 2012, the University of Chicago's Booth School

of Business surveyed a group of elite economists from varying fields of expertise and ideological outlooks. Ninety-eight percent of them agreed that public pension discount rates are too high. Biggs cited other research, from the Congressional Budget Office, the Federal Reserve, academic economists, and others, that all point to the same conclusion: the high discount rates that Missouri pensions use substantially underestimate the true value of these plans' liabilities and overstate their funding health.

Currently, the state's largest public plans are defined benefit (DB) plans. The state promises to pay its retirees a pre-determined monthly amount based on a variety of factors, including final salary, age, and tenure. To contain the growth of public pension liabilities, the state should align benefits to contributions. Transitioning current plans to better designed alternatives (e.g., defined contribution, hybrid defined contribution/defined benefit, cash balance, etc.) can accomplish this.⁴

Shifting away from DB plans as structured has been met with fierce opposition in the past.⁵ One of the points raised against shifting toward a more efficient system is that by shifting to a new system, other costs to the state would be imposed before any savings will be seen.⁶

These "transition costs" come in two types. First, plans perceive that the Government Accounting Standards Board (GASB) will require an accelerated repayment of unfunded liabilities if the current plan is closed. Second, there is a perceived need for a closed plan to shift its holdings to

less risky, more liquid assets as the plan's members age. These assets are expected to generate a smaller return and thus require higher contributions.⁷

Biggs addressed these concerns in his new policy study for the Show-Me Institute, "Missouri Transition Costs and Public Pension Reform." In response to the first type of perceived transition cost, Biggs found that, "GASB accounting standards are guidelines for disclosure; these guidelines are not intended to dictate funding policy. Recent reforms to GASB guidelines make clear that they are intended to measure pension liabilities, not determine how pension liabilities should be funded." Biggs also stated that there would be no economic or policy reason to increase the rate of repayment of unfunded liabilities.⁸

As to the second type of perceived transition cost, Biggs wrote, "Increasing the liquidity of plan investments would have only small effects on expected returns. A closed plan's investments must be truly liquid only in the final years before true shutdown, which would be decades in the future." Also, if pension plans were valued using lower discount rates, as Biggs recommends, closing a plan would have only a small effect on a plan's liabilities.⁹

In order to protect taxpayers from significantly increased future burdens, the state should take preemptive steps to ensure pensions can meet their obligations. These steps include (1) using a more realistic discount rate to accurately gauge the state's true pension obligations

There is nearly universal support among economists for using low discount rates to value public pension liabilities.

and (2) shifting away from currently structured defined benefit plans toward more effectively structured plans. These steps will help ensure that the state has a better picture of its pensions' financial conditions and prevent the accrual of additional liabilities.

Fears about so-called transition costs should not stand in the way of enacting real pension reform. In summarizing his conclusions regarding transition costs, Biggs wrote, "...claims of transition costs are, at some times, overstated and, at other times, entirely mistaken."¹⁰ Thus, the transition cost issue is not one that should prove an obstacle toward major reform.

The state needs to better account for risk in order to start reforming public pensions.

NOTES:

¹ Biggs, Andrew. "Public Employee Pensions in Missouri: A Looming Crisis." Show-Me Institute Policy Study. March 11, 2013. View online here: <http://showmeinstitute.org/publications/policy-study/taxes/922-ps36-biggs-public-pensions.html>.

² Ibid.

³ Private sector defined benefit plans are required to value their liabilities using the yield on a portfolio of high-quality corporate bonds. As of February 2012, the yield in the Citibank Liability Index is 4.6 percent.

⁴ Portions of this testimony were taken from: Shuls, James V., and Michael Rathbone. "Missouri Transition Costs and Public Pension Reform." Show-Me Institute Policy Briefing. February 2014. View online here: <http://www.showmeinstitute.org/publications/policy-study/taxes/1109-missouri-transition-costs-and-public-pension-reform.html>.

⁵ Ganey, Terry. "Speakers oppose state pension shift." *Columbia Daily Tribune*. Feb. 18, 2010. View online here: http://www.columbiatribune.com/news/politics/speakers-oppose-state-pension-shift/article_058330a5-0cf7-5a62-a219-8d420e-ca4583.html.

⁶ The executive director of MOSERS raised this transition cost issue in his comments regarding one of Biggs' publications. Read the complete back and forth online here: <http://pensiondialog.wordpress.com/2012/05/24/pension-transition-cost-myths/>.

⁷ Biggs, Andrew. "Missouri Transition Costs and Public Pension Reform." Show-Me Institute Policy Study. Feb. 17, 2014. View online here: <http://showmeinstitute.org/publications/policy-study/taxes/1093-missouri-transition-costs-and-public-pension-reform.html>.

⁸ Ibid.

⁹ Ibid.

¹⁰ Ibid.

*Fears about so-called
transition costs
should not stand in
the way of enacting
real pension reform.*



4512 West Pine Blvd. | Saint Louis, MO 63108 | 314-454-0647 | www.showmeinstitute.org

View State Government Spending:
showmeliving.org

Read Our Blog:
showmedaily.org

Use Our Interactive Database:
showmedata.org

Find Us on Facebook:
facebook.com/showmeinstitute

Follow Us on Twitter:
twitter.com/showme