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SENATE BILL 228 AND MODIFICATION OF THE YEAR 2000 RETIREMENT PLAN

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Testimony before the Senate Health and Pensions Committee

TO THE HONORABLE MEMBERS OF THIS COMMITTEE:

My name is Michael Highsmith 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 that analyzes the financial state of Missouri public pensions and discuss potential reforms that could be implemented to improve the sustainability of those pensions.

Unfunded liabilities of public pensions are a looming crisis nationwide. The Pew Charitable Trusts has valued the funding gap in the nation's state-run retirement systems at more than 1 trillion dollars. This gap represents the promises plans have made to employees regardless of how investments perform during an employee's work life. If investment returns fall short of expectations, then taxpayers must fund the difference.

SB 228 modifies the Year 2000 Retirement Plan for state employees, members of the general assembly, and statewide elected officials. The current Year 2000 plan promises to pay its retirees an annuity for life equal to 1.7 percent of their final average pay multiplied by an employee's number of years of service. It also promises members of the general assembly and statewide officials an annuity equal to 1/24th of their monthly salary multiplied by their number of years of service. SB 228 reduces the multiplier for employees from 1.7 percent to 1 percent, and reduces the multiplier for general assembly members and statewide officials to 1/48th. These changes would apply to plan participants hired on or after January 1, 2018. The changes would not apply to retirement funds for employees/members who were hired before this date.

In addition to the changes listed above, SB 228 stipulates that employees shall participate in the state's deferred compensation program and receive an employer contribution rate of 3 percent along with the current contributions. (Currently, employees who participate in the plan contribute 1 percent of their salary and receive up to $75 per month from the state.) The deferred compensation program does not promise an annuity, but instead grants retirees the funds that have grown during their time of employment by the state.

Finally, SB 228 modifies the ceiling of the annual cost-of-living adjustment to each plan participant's compensation formula so that the adjustment cannot exceed 2 percent per year (the previous maximum was 5 percent).

MISSOURI'S FISCAL POSITION

Missouri's current pension plans are no exception to the nationwide trend of growing unfunded liabilities. In 2016 the Missouri State Employee Retirement System's (MOSERS) plan administrators valued its unfunded liability at approximately $3.87 billion using a discount rate of 7.65%.[1] It should be noted that in 2013 MOSERS used a discount rate of 8% and valued its unfunded liabilities at $3.03 billion, and Andrew Biggs of the American Enterprise Institute estimated that MOSERS unfunded liability was closer to $9.61 billion by using a corporate discount rate of 4.26%.[2] Applying the same assumptions that Biggs used in his valuation to MOSERS's 2016 reported figures yields an estimated unfunded liability of $10.45 billion.

Funding gaps occur primarily for the following reasons:

Underfunding: If a public sector employer does not contribute the full actuarially determined amount required to properly fund a plan each year, then even if the investments match their assumed return rates, the plan's funding gap will widen as returns are compounded. Policymakers can be tempted to underfund pensions and use the money saved for other municipal services, but in the long run this practice only exacerbates funding problems.

Underperformance: If a plan puts in what is actuarially recommended each year but its investment returns are not as large as expected, the funding gap will widen. Overestimating investment performance can significantly increase unfunded liabilities, and 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 (as determined by plan administrators) are too high.[3]

Unanticipated distributions: Increasing life spans can place stress on pension funds when retirees receive funds for a longer period of time than plans initially predicted.

Employees who enroll in defined benefit (DB) plans expect to receive the benefits they are promised, but the policymakers who make those promises often are not the ones held accountable when a plan experiences a shortfall. Because employees hired in 2018 are unlikely to retire for many years, the next generation's taxpayers are the ones who will foot the bill if benefits are overpromised today. Exercising restraint on promising large benefits is difficult, but it is the fiscally responsible move in order to assure intergenerational equity.

If the end goal of large retirement benefits is to increase employee retention, there may be better uses for public dollars. In October 2016 Cory Koedel, an associate professor of Economics at University of Missouri, released a paper that examined past pension formula enhancements for teachers in St. Louis Public Schools and what effect they had on employee retention.[4] The study found no evidence that pension enhancements generated differential increases in employee retention. Koedel wrote:

> *It seems likely that the funds currently devoted to support teacher DB plans could be redeployed in a more strategic manner to promote the highest quality workforce for students in K-12 schools.*[5]

The study focused on school teachers, but the underlying concept suggests that generous benefits may not sufficiently improve employee retention to justify the costs. If schools or other public bodies are interested in retaining employees, it could be more effective, and also more financially responsible, to offer higher salaries.

PENSION REFORM

SB 228 shifts a greater portion of retirement investments into the deferred compensation plan, but it does not eliminate the risk that pension costs pose to Missouri. The DB portion of the Year 2000 plan still has the potential to accrue unfunded liabilities. DB plans depend upon predictions regarding investment returns and employee life-spans, So if a plan's investment returns fall short of their goals and the plan lacks sufficient money to make the necessary payments, taxpayers are still legally bound to fund the difference.

An alternative, and one that is fiscally more responsible for taxpayers and public employees, is to move the current DB plan structure to a defined contribution (DC) plan for employees hired on or after January 1, 2018. DC plans consist of employer/employee contributions into individual accounts—think 401(k)—which employees can manage as they see fit. Upon retirement, the funds are available to employees. DC plans differ fundamentally from DB plans in that they cannot incur unfunded liability (so taxpayers are never on the hook). The deferred compensation program referred to in SB 228 is an example of a DC plan, so moving a larger portion of benefits into this program helps lower future liability risks for the state but, make no mistake, it does not eliminate them.

In addition to avoiding funding gaps, DC plans are transferable from one job to another and reduce the political incentive to overpromise benefits today when the costs of those promises won't be felt for many years.

Of Missouri's 128 public retirement plans, 78 are DB, 38 are DC, and 12 are a combination of the two plan types. To contain the growth of public pension liabilities, the state should better align benefits with contributions. Transitioning current plans to better-designed alternatives such as DC planscould accomplish this.

In order to protect taxpayers from significant future burdens, policymakers should take preemptive steps to ensure that pensions can meet their obligations. These steps include (1) using a more realistic discount rate to accurately gauge the state's true pension obligations, (2) evaluating current pension benefits and deciding if they are feasible given current investment returns, and (3) shifting away from DB plans towards DC plans that are not subject to underfunding. These steps will help ensure that the state has a better picture of its pensions' financial conditions and prevent the accrual of future additional liabilities.

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ENDNOTES

1. MOSERS Actuarial Annual Report Fiscal Year Ended June 30, 2014

2. http://showmeinstitute.org/sites/default/files/20151207%20-%20The%20Funding%20Health%20of%20Local%20Government%20Pensions%20in%20Missouri%20-%20Biggs.pdf

3. http://www.igmchicago.org/surveys/u-s-state-budgets-revisited

4. https://ipp.missouri.edu/wp-content/uploads/sites/2/2016/10/Policy-Brief-10-2016.pdf

5. https://www.brookings.edu/blog/brown-center-chalkboard/2016/09/30/pension-incentives-and-teacher-retention/

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