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# TESTIMONY

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# MISSOURI'S PUBLIC PENSIONS: WORSE THAN THEY APPEAR

**By Michael Rathbone**

***Testimony Before the Joint Committee on Public Employee Retirement***

***The unfunded liabilities of the state's public pensions are an economic ticking time bomb, which the state is obligated to honor.***

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

**To the Honorable Members of This Committee:**

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 based solutions for state policy. The ideas presented here are my own. This testimony is intended to summarize research performed for the Show-Me Institute that analyzes the financial state of Missouri's public pensions.

The unfunded liabilities of the state's public pensions are an economic ticking time bomb, which the state is obligated to honor. By incorrectly assessing the risk of not being able to meet future liabilities, these pensions significantly underestimate the amount of additional funding they need in order to be financially secure. A new policy study for the Show-Me Institute shows that if these public employee pensions use a more appropriate discount rate, they pose a real threat to the state's finances.

If left unaddressed, the state faces a significant risk and policymakers will be forced to make drastic cuts to services or significantly raise taxes in order to meet the liabilities. The risk posed to Missourians' quality of life is a real and serious one. The study estimates that the liability equals nearly $9,000 for every Missourian.

Reforms to public pensions must begin with better economic accounting for risk and improved retirement plans that reduce taxpayer exposures to bad surprises in the future. Taxpayers, state officials, and public employees have all expressed concern about the financial health of Missouri's public pension plans for state employees. These plans' funding health has declined in recent years and current annual required contributions have increased.

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

- Missouri State Employees Retirement System

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(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 2012 of $11.1 billion and a funding ratio of 81 percent.

However, this official amount vastly underestimates the true liability of these pensions. In "Public Employee Pensions In Missouri: A Looming Crisis," a new policy study for the Show-Me Institute, Andrew G. Biggs finds that the real amount of unfunded liabilities is closer to $54 billion – which translates to nearly $9,000 for every man, woman, and child in the state.

Why is the value of these unfunded liabilities **five** times larger than official reports indicate?

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 use.

A discount rate is basically compound interest acting in reverse. If, for instance, I owed 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, the lower the amount I need to invest. Assuming I could get a robust 12 percent annual return on my money, I would need to invest only $3,200 to repay my loan. However, if I believed I would only get an annual 4 percent return on my money, I would need to invest $6,800.

The state's public pension plans use discount rates between 7.25-8.25 percent. This enables them to assume their current assets will be worth more in order to pay off their liabilities. Biggs uses a lower rate that better accounts for the risks inherent in a portfolio with risky assets and guaranteed liabilities.

Missouri public pensions expect returns between 7.25-8.25 percent on their portfolios but 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 cites other research, from the Congressional Budget Office, the Federal Reserve, academic economists, and others, that all points to the same conclusion: the high discount rates that Missouri pensions use substantially underestimate the true value of these plans' benefit liabilities and overstate their funding health.

Currently, the state's largest public pensions 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, Biggs suggests that these plans might shift to a defined contribution (DC) structure similar to private sector 401(k)s.[1] By shifting away from DB plans and toward DC plans, the state can prevent the creation of new liabilities. With a DC plan, employers promise employees a fixed contribution and once they make that contribution, the employers have fulfilled their obligation. Biggs contends that doing so will give state and local governments breathing room to address the unfunded liabilities already on their books. In addition to shifting to a DC plan, Biggs has suggested other methods to deal with the pension shortfalls, including ways to compensate for any surpluses/shortfalls that a pension might encounter.

The state's public pensions are not in good financial health. Even according to the overly optimistic calculations of the state's pensions, these plans still face a financial shortfall. According to Biggs' more realistic analysis, their total unfunded liability is much larger than their official financial statements would indicate. These are liabilities that the taxpayers are responsible for meeting. In order to protect taxpayers from significantly increased future burdens, the state should take preemptive steps to ensure these pensions can meet their obligations. These steps include (1) using a more realistic discount rate to accurately gauge the state's true pension obligations and (2) shifting away from defined benefit plans toward defined contribution plans. These steps will help to ensure that the state has a better picture of its pensions' financial conditions and prevent the accrual of additional liabilities.

# NOTE

[1] I realize that there might be legal and political difficulties in making a transition to a defined contribution plan. This testimony is not intended to address these difficulties. It only highlights the desirability of making the transition.



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