



REDEFINING EARNABLE COMPENSATION IN THE RETIREMENT SYSTEM FOR NEW AND NON-VESTED MEMBERS IN SERVICE

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BACKGROUND

As the New Hampshire legislature considers a proposal to switch the state's pension system from a defined benefit plan to a defined contribution plan, assessing the costs of doing so must begin with an accurate accounting of the liabilities present in the current system.

According to the Comprehensive Annual Financial Report for FY 2011 for the New Hampshire Retirement System (NHRS), the state faces an unfunded liability of \$4.25 billion for its public sector workers.² The system is only 57 percent funded. However, when valuing this liability using methods that economists agree are more accurate and reflect the government guaranteed promise to pay these benefits, the true unfunded liability in the NHRS is closer to \$16 billion, and the system is only 26 percent funded.

The reason for this discrepancy can be traced to current government accounting guidance contained in Government Accounting Standards Board (GASB) ruling 25, which states that a pension liability may be valued using a discount rate based on what the pension assets are expected to return when invested in the market. However, this approach violates several well-established principles of economics, including the mixing of assets and liabilities for the purpose of valuation.³

The correct approach to valuing a pension liability is to match the discount rate to the risk-free guarantee presented by the liability—that is, the state's promise to pay out the benefit. A much more suitable rate to use is the

1. Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2011, p. 38. http://www.nhrs.org/documents/NHRS_CAFR_FY2011.pdf
2. For a discussion of pension liability valuation see, "Robert Novy-Marx and Joshua Rauh, "Public Pension Promises: How Big Are They and What are They Worth?, Working Paper, December 2009, <http://ssrn.com/abstract=1352608>. and Eileen Norcross "Getting an Accurate Picture of State Pension Liabilities," December 13, 2010, Mercatus Center On Policy, Mercatus Center at George Mason University. <http://mercatus.org/publication/getting-accurate-picture-state-pension-liabilities>

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yield on 15-year Treasury bonds, currently at 2.4 percent. Lowering the discount rate has the practical result of increasing the present value of the liability and thus the amount of money needed to fund the promised benefit.

Plans across the nation have been using high discount rates, averaging 8 percent to measure their liabilities, and thus understating the true size of those commitments in the present and setting aside too little money over time to fund those promises. Thus, even where NHRS is making 100 percent of the annual contribution to the system, it is contributing too little.

Another result of GASB 25 is that by using discount rates based on what the assets are expected to return, rather than on the risk-free characteristics of the liability, plans have sought to take on more investment risk. New Hampshire's plan reflects this behavior. Currently the portfolio consists of 63.9 percent equities, 24.6 percent in fixed income investment, 3.6 percent in cash equivalents 7.7 percent in real estate and 2.1 percent in alternatives. Contrast this to private defined benefit plans. On average, corporate pension plans hold 40 percent in equities, roughly 40 percent in fixed income, and the remaining 20 percent distributed among cash equivalents, real estate, and alternatives. Private defined benefit plans portfolios are less exposed to market risk.⁴ More risk is being borne in public pension plans than in corporate defined benefit portfolios—a direct result of the flawed guidance of GASB 25 which implies it is possible to lower one's debts by embracing more market risk.

Other pension management choices brought about by GASB 25 include the usage of apparent (but fictitious) plan surpluses to offer benefit enhancements, skip contributions, or reduce employee contribution rates. These actions, stemming from the initial liability misvaluation, have weakened pension plans in state and local governments.

CONSIDERATIONS FOR REFORMING NEW HAMPSHIRE'S PENSION SYSTEM

As reported, New Hampshire's unfunded pension liabilities are high and the NHRS is poorly funded. On a market basis the problem is four times worse. This presents the state with some very important policy decisions. Namely, how to ensure that the promises made to workers are honored and the benefits earned are paid out without placing an undue burden on taxpayers and younger employees. Recognizing the risk inherent in the current defined benefit system has led the New Hampshire legislature to consider closing the current plan to new hires and replacing it with a defined contribution plan, or possibly a hybrid plan. We now consider a question of the committee:

1. Does a Defined Benefit plans provide a lower cost approach for the state than a Defined Contribution Plan?

There are on-budget costs for the state under both defined benefit and defined contribution plans. These costs should be evaluated in terms of both short-run budgetary tradeoffs and the longer-run political economy context.

Defined Benefit plans have become far more costly than anticipated because they have been misvalued. The guaranteed, safe retirement that is promised by the DB model has been managed as though it is a risky investment. This misvaluation has exposed plans to investment risk and led to the systematic underfunding of the plan, which entails an immediate and growing cost burden for the state as well as long-term risk. For this risk to be eliminated, the DB plan must be properly valued, using market valuation and funded accordingly. This means that contributions need to rise steeply in the short run.

Maintaining the current DB plan is not costless, and in fact could result in a far less generous retirement for younger workers who may be asked to contribute greater amounts of their salary to fund present benefits.

Switching new hires to a Defined Contribution plans presents another set of costs to the government. The yearly management costs of defined contribution plans are higher. One study finds that administrative costs for defined

3. Karl G. Mergenthaler and Helen Zhang, "Public Pension Funds: Asset Allocation Strategies," http://www.jpmorgan.com/tss/General/Public_Pension_Funds_Asset_Allocation_Strategies/1289431691010

benefit plans represent 0.43 percent of plan assets and in defined contribution costs represent 0.95 percent of plan assets.⁵ But these costs are trivial as compared to the costs presented by transition.

Another up-front cost in the DC plan is that the state must make its annual contribution to individual workers' retirements. If New Hampshire decides to switch to a DC plan it must at the same time make the annual payment to those participating in a new DC plan and continue to fund the existing defined benefit system. The short-run budgetary costs are significant. But the long-term fiscal gains must also be considered. In the long run the risks present in the DB system are shifted off of the government's balance sheet and away from taxpayers.

To handle the transition costs—that is the cost of funding the benefits accrued to workers while contributing to new hires' DC retirement accounts—the government could issue a one-time bond to fund the transition.⁶ The borrowing should be one-time, and it should total the present value of all future payments owed to all retirees who do not transition to the 401 (k) system. Michigan had a fully funded plan in 1997 and made the switch. This helped the state to cap its unfunded liabilities, saving the state billions of dollars in unfunded liabilities

Since the risk of retirement investments in a DC plan is shifted to the individual employee, workers tend not to favor such a switch. However, what should be made abundantly clear is that the management and valuation of DB plans has effectively turned a guaranteed retirement into one that is riddled with risks for employees and taxpayers due to how plans have been valued, funded and invested – ostensibly these risks will be borne by taxpayers, and younger employees. The fact that accrued benefits must be paid may give older employees who are fully vested and current retirees a false sense of confidence in the security and safety of the DB plan as currently structured.

The question for policymakers is how to design a retirement system for public employees that has the following characteristics: safety, stability and intergenerational fairness for workers, efficiency for the government and one that minimizes the risk to taxpayers.

There are a few options. To address the concern that a 401(k) presents too much risk for the employee, a new DC plan need not be modeled after the corporate 401(k). Other potential models include the TIAA-CREF plan, a plan in which employees invest in a limited list of low-risk funds, and the Federal Thrift Savings Plan, a hybrid plans that combines a small defined benefit plan, a 401(k) plan and Social Security.

Another positive feature of DC plans is that they offer the worker mobility and allow the employee to carry their retirement savings as they change careers. The political manipulation witnessed in DB plans (again, a function of valuing liabilities based on asset performance), is attenuated, if not eliminated in a DC plan.

Michigan made this transition in 1997. All employees receive a 4 percent contribution from the state to their individual retirements, and employees may contribute up to 20 percent on a pre-tax basis. The state also matches employees for the first 3 percent of their contribution. Effectively, an employee can be assured of an annual contribution of 10 percent of their income towards retirement, the amount recommended for an adequate income in retirement.

In conclusion, the case for DC plans is that they reduce the fiscal and taxpayer uncertainty present in DB plans. They do not present the same risks and bad incentives in public sector defined benefit plans that now threaten the retirements of public sector workers across the country.

Transition costs can be high and may be best handled through the issuance of a one-time bond. The merits of a DC plan, structured to reflect the low-risk preferences of public sector workers is that it obligates the government to

4. Alicia Munnell, Jean-Pierre Aubry, Josh Hurwitz and Laura Quinby, "A Role for Defined Contribution Plans in the Public Sector," Center for Retirement Research at Boston College, State and Local Pension Plans Number 16, April 2011. http://crr.bc.edu/images/stories/slp_16_508.pdf

5. Scott A. Beaulier, "From Defined Benefit to Defined Contribution" Working Paper No. 11-37, Mercatus Center at George Mason University, September 2011.

make its annual contribution to workers' retirements and attenuates the risk to taxpayers, while providing workers with greater choice and personal mobility.

As the state maintains the DB plan for current employees, it must abandon the current accounting and switch to market valuation. Current account rules effectively guarantee that DB plans remain undervalued and underfunded assuring the need for higher future revenues and less stable fiscal future for New Hampshire. Additionally, the state might consider shifting the management of the fund to an outside entity, which would align incentives to provide an accurate accounting of benefits.⁷

CONCLUSION

The crisis in public pensions is the result of years of policy based on an erroneous valuation of the promise made to public sector workers. By mixing together the valuation of assets and liabilities, plan managers and policymakers have been falsely led to believe they can take on greater investment risk with pension assets and somehow simultaneously reduce the value of the pension obligation. The result is too little money has been set aside, systematically and too much risk has been taken. The unfunded liabilities in public sector pension plans are the unfortunate casualty of a confused approach to liability valuation. The practical result for New Hampshire is a deep funding gap in the state's pension system that is four times larger than currently reported. This will necessitate budgetary tradeoffs in the near future as the state seeks to fulfill these commitments.

The question this raises is how to design a retirement system for workers that removes the risk to taxpayers while providing a stable, predictable retirement for public sector workers:

The merits of a defined contribution plan for workers are as follows: greater choice and mobility for the workers, less risk for the taxpayer, and a guaranteed annual contribution to the employee's retirement savings.

The costs of transition to a defined contribution plan are not negligible since the state will have to continue funding benefits for employees in the current system until all have retired. At the same time the state must contribute to the retirement savings of new hires in a DC plan. Michigan provides an example of a state that made such a transition in 1997, and has saved the state billions in unfunded liabilities. The DC plan can be structured to reflect the low-risk preferences of public sector workers. Alternatively, the state might consider a hybrid approach, such as the Thrift Savings Plan offered by the federal government to its employees.

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6. Eileen Norcross and Roman Hardgrave, "Accounting for the Cost of a Public Sector Worker in New Jersey," Working Paper, No. 11-38, September 2011, Mercatus Center at George Mason University, http://mercatus.org/sites/default/files/publication/Norcross_AccountingfortheCostNJ_9.28.11_0-1.pdf