Analysis of Joshua Rauh's Paper, "Are State Public Pensions Sustainable?"[1]

A recent paper uses unrealistic assumptions to exaggerate the financial condition of state and local government employee retirement systems. The author also recommends changes to these programs that would only serve to exacerbate their financial condition. By vastly underestimating states' projected future contributions to their pension plans and their expected investment returns, the paper draws dramatic and improbable conclusions regarding the plans' solvency. The paper further ignores reforms already underway in the states that will restore sustainability to a far greater degree, and with far fewer costs and disruptions, than those proffered in the paper.

"Are State Public Pensions Sustainable?," written by Northwestern University Assistant Professor Joshua D. Rauh, is unduly alarmist and relies on flawed methods and assumptions.

1. A premise central to Professor Rauh's projections is that states and localities will make atypically low contributions to their pension plans going forward. He assumes future contributions "will be sufficient to fully fund newly accrued or recognized benefits … but no more." This ignores the fact that plans must also pay down unfunded liabilities (the portion of accrued benefits that have not yet been advance-funded), which are in most cases protected by contract and/or statute and must also be funded.

   Rauh's presumption is also unsupported by current practice. Based on Public Fund Survey data, public plans have been receiving contributions that not only are enough to cover newly accrued benefits, but also help pay off the cost of benefits accrued in the past. In fact, from FY 01 to FY 08, on average, pension plan sponsors paid 92 percent of their required contributions. In addition, most plans do so using a more conservative funding approach than that assumed by Professor Rauh.

2. Confusion also has resulted from the release of multiple versions of Professor Rauh's projections. At least one of these versions calculates unfunded pension liabilities by assuming funds will only generate rates of return equal to those provided by all-bond portfolios. By contrast, the standard method for calculating liabilities assumes that pension funds earn a real return of 5.0 percent annually, based on the mix of assets they typically hold - a more reasonable assumption, given the current ratio of stock prices to trend earnings.[2] Further, analysis shows that public pension funds' actual long-term investment returns still exceed this assumption.[3]

3. Professor Rauh's analysis also does not account for changes that have been made and undoubtedly will continue to be made to improve the long-term sustainability of state and local government pension plans. More than one dozen states this year alone have made fundamental changes to their pension plan benefit or contribution rate structures, or both.[4] Countless more local governments have made adjustments, and more than half of the states have made some modification to their retirement systems over the past five years. Ignoring these changes results in an inaccurate picture of the current situation and disregards the measured approach that can be and has been taken to close pension funding gaps, with lower costs and less disruption.

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[1] Based on analysis prepared by Paul Zorn and Mita Drazilov at Gabriel, Roeder, Smith & Company, Paul Angelo at The Segal Company, and Keith Brainard at NASRA.

[2] "More Scare Stories About State Pensions at the NYT," Dean Baker, Center for Economic and Policy Research, June 20, 2010.

[3] "NASRA Issue Brief: Public Pension Plan Investment Return Assumptions," National Association of State Retirement Administrators, March 2010.

[4] "Pensions and Retirement Plan Enactments in 2010 State Legislatures," Ron Snell, National Conference of State Legislatures, May 17, 2010.

4. The recommendation made by Professor Rauh to close pension plans to newly-hired governmental employees, and instead enroll them in Social Security and a defined contribution plan, ignores the significant additional costs that would be imposed by such changes. Conservative estimates of the added expense to public employers and their employees of mandating newly hired workers into Social Security find it would be over $44 billion in the first five years alone,[5] and would worsen the financial condition of the sponsoring governments and their pension systems.

   Moreover, although defined contribution plans are a useful means of supplementing pension benefits, they are inherently not as effective or efficient as a primary source of retirement income. By pooling mortality and investment risks, defined benefit pension plans reduce participants' risk of outliving retirement assets, and can provide the same benefit at nearly half the cost of a defined contribution plan.[6]

   Also, in contrast to the defined contribution plans Professor Rauh proposes, defined benefit plans offer disability and death benefits. Death and disability benefits are especially important for state and local government employees in hazardous occupations such as firefighters and police officers, who face higher risks in the line of duty. Switching to a defined contribution plan would require that these benefits be provided through commercial insurance, likely at significantly higher costs to the employer.

5. The suggestion by Professor Rauh that State and local governments should issue debt to fund their pension benefits simply adds risk to the funding equation. Such debt would become a liability for the sponsoring government. If the markets fall after the funds are invested, the government now has two sets of liabilities: the outstanding debt and the pension liability. Even with a federal subsidy, (which is unlikely given current federal government budget constraints and which raises additional challenges), this could be a risky approach.[7]

6. Rauh's analysis is not accompanied by information necessary to identify and analyze his underlying assumptions regarding modeling of future cash flows. This leaves the basis for his projections unclear. For example, it is unknown whether the data Professor Rauh uses to estimate new liabilities related to service costs, in Figure 2 of his paper, includes changes in liabilities related to changes in plan assumptions. If a plan lowered assumed rate of return on investments in 2007, for example, the plan's liabilities would increase in a way unrelated to service costs. For a more consistent comparison, the underlying data would need to be adjusted for changes in assumptions; otherwise the new liability related to service costs would be overestimated.

Finally, some of the broader points Assistant Professor Rauh makes with regard to public pension liabilities and possible solutions, are based on inconsistent or misleading comparisons that fail to account for the fact that most *state-based* pension plans actually include *local* government employers and employees, and that these state-based plans rely on contributions from these local sources. **Although pension plans have grown in size, pension fund contributions currently account for approximately three percent of all state and local government spending, and contributions as a percentage of employee payroll remain at or below historical levels.**[8]

Assistant Professor Rauh's concern over the difficult financial situation that state and local governments face in the current economy is shared and appreciated. **However, his analysis and recommendations may not be helpful for addressing the short- or long-term fiscal health of state and local governments or their retirement systems.**

[5] "The Cost Impact of Mandating Social Security for State and Local Governments," Cathie Eitelberg, Alexander Sussman, F.S.A., and Leslie Thompson, Revised 2005.

[6] "A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans," Beth Almeida, William B. Fornia, FSA, National Institute on Retirement Security, August 2008.

[7] "Evaluating the Use of Pension Obligation Bonds," *Government Finance Officers Association Advisory* (1997 and 2005).

[8] U.S Census Bureau and "NASRA/NCTR Issue Brief: Market Declines and Public Pensions," National Association of State Retirement Administrators and National Council on Teacher Retirement, December 2008.