

Testimony of Edmund J. McMahon
Senior Fellow, Manhattan Institute for Policy Research
Empire Center for New York State Policy

Before the Joint Legislative Fiscal Committees
January 25, 2012

As part of his 2012-13 budget legislation, Governor Cuomo has proposed the most significant and potentially far-reaching reform of New York public pensions in at least 36 years. While the governor's plan is far from being an ideal solution to the problem of exploding pension costs and long-term liabilities, it includes some significant steps in the right direction, which are worthy of serious consideration and support. I would like to explain why this is so – and how you might improve on the governor's proposals.

New York's current defined-benefit pension system represents a significant financial and generational trade-off, the costs of which have not been sufficiently recognized. Current government employees are promised a constitutionally guaranteed benefit, the closest thing to absolute retirement security, which replaces a relatively high percentage of their pre-retirement income and is ultimately supplemented by full Social Security benefits. Taxpayers get to assume all the financial risk associated with delivering on this promise -- while also saving for their own retirements.

Over the years, New Yorkers have been exposed to many news stories about the many ways in which the public pension system has been exploited, gamed or otherwise taken advantage of by those seeking to maximize their benefits. I won't dwell on those instances today, because I do not believe they are at the core of the problem. By any standard, public pension benefits are very generous -- and they will remain so even if you close loopholes for overtime spiking, double-dipping and other abuses. Government workers can retire earlier and with much larger retirement incomes than private sector counterparts – without even counting the invaluable financial security afforded by the system, buttressed by low-cost or even free health insurance coverage.

The level of benefits contributes to cost but is only part of a bigger problem: the current public pension system, in New York as in most other states, exposes taxpayers to intolerable levels of financial risk and volatility. To make matters worse, government accounting standards allow our state and local retirement systems to severely understate the true cost of pension benefits – and the full extent of the long-term liabilities they have created for New Yorkers, now and in the future. That's because defined benefit systems in the public sector are allowed to discount their liabilities using their ambitious target rate of return on investments, typically 7.5 or 8 percent. Private pension plans must discount liabilities based on what's known as a "market" rate – such the interest paid on bonds issued by financially solid corporations. This is often much lower than the plans' projected returns – closer to 5 percent – but it reflects what the money would be earning if invested in low-risk assets, matching the low risk tolerance of future retirees who are counting on their promised pensions. A higher discount rate artificially reduces the size of the long-term liability.

An example of the consequences: as of the end of fiscal 2009, the New York State Teachers' Retirement System was among the strongest in the country by governmental accounting standards, with a funded ratio equal to 103 percent of its "actuarial" liabilities. But using a more conservative market standard, my colleague Josh Barro calculated the system was only 60 percent funded – in effect, nearly \$49 billion short of what it would need to make good on all its obligations, if you properly priced the valuable guarantee taxpayers provide to retirees. The financial condition of the NYSTRS has improved since then, thanks to stronger market returns in 2010 and 2011, but the system is still undoubtedly still under-funded by private sector standards. And, as we meet today, the S&P 500 is still below the level of last June 30, when NYSTRS closed its last fiscal year.

Ideally, to cap the financial risks once and for all, New York's existing defined-benefit (DB) public pension plans would be closed to new members. Future hires would be placed in defined-contribution (DC) plans such as the 401(k) accounts that most private workers rely for their own retirement, or in "hybrid" plans, combining elements of DB and DC plans, carefully designed to cap the taxpayers' financial exposure and to require employees to share more of the financial risks inherent in planning for retirement planning.

This is not just a matter of financial necessity but of basic fairness to current and future taxpayers – the vast majority of whom, it bears repeating, will never receive anything approaching the benefits available to public employees.

Over the past 10 years, annual taxpayer-funded employer contributions to public pension funds have risen by \$12 billion, including nearly \$7 billion in New York City alone. They will continue rising for years to come, thanks to a combination of the added cost of benefit enhancement enacted by the Legislature in 2000 and the severe investment losses in the following decade. The net assets of the New York and Local Retirement System have grown by barely 16 percent since 2000, but total benefit payments during the same period had more than doubled, and similar patterns can be observed in the other pension funds.

It is possible that stronger-than-expected market performance will bail out state and local governments and blunt the coming spike in contribution rates. It's also possible that we are about to enter another lost decade of wildly volatile swings in asset prices, ending in little or no gain at all. No one knows for sure – but only one party in this transaction, the taxpayers, needs to worry about it. And that's a problem.

The long-term costs of New York's past pension promises were obscured or grossly understated until it was too late. Now the system is demanding more of taxpayers when they can least afford it. To borrow a computer programming phrase, *that's not a bug -- it's a feature* of defined-benefit public-pension plans across the country.

Governor Cuomo's plan would attempt to alleviate the situation in three ways.

First, it would raise employee contributions, reduce benefit multipliers, and increase the retirement age and vesting period for most plans. By itself, these changes would reduce the expected "normal" cost of pensions, but they would not address the underlying financial risks, opacity and unpredictability of the system. Furthermore, there is no guarantee that, once adopted, these new parameters would remain unchanged. If the 40 year history of "pension reform" in New York teaches us anything, it is that the

Legislature will face relentless pressure to undo the changes in a defined benefit Tier 6 until it more closely resembles Tiers 4 and 5. The cost of such moves toward "tier equity" will never be acknowledged, until it is too late.

A second, more valuable reform proposed by the governor would create a "risk/reward" mechanism that would require workers in the new tier to bear part of the cost when pension contributions exceed the "normal" rate, and to share in benefits when costs are lower than the rate. For the first time ever, New York's public employees would actually be required to at least share in the financial risk associated with their pension plans. A provision like this would have saved taxpayers across the state billions of dollars over the past decade.

Finally, and most significantly, the governor would give all public employees access to the optional defined contribution system offered to employees of the State University of New York. Over the years, thousands of SUNY employees have retired under this system. The number of plans offered has been expanded from a single provider, TIAA-CREF, to a total of four plan managers, including Fidelity, VALIC and Metropolitan Life. According to the latest SUNY statistics, these defined contribution plans are the voluntary choice of 70 percent of university employees who belong to any employer plan, including 77 percent of faculty members. They enjoy the benefit of a plan that offers full portability, a range of professionally managed investment choices, and full vesting after just one year - compared to 10 in the current Tier 5 pension system and 12 under the governor's defined benefit proposal.

The defined contribution option has been widely misunderstood - and widely misrepresented. Some have even suggested that employees choosing such a plan will end up destitute and dependent on Food Stamps -- which will come as news to thousands of retired SUNY staff members, not to mention millions of other public- and private-sector retirees who have secure retirement incomes from defined contribution plans. Other critics have focused more broadly on some of the well-publicized shortcomings of 401-k accounts offered in the corporate sector, particularly the tendency of employees to save too little. But these comparisons ignore the comparative strength of the SUNY optional plan, in which employees build up significant savings based on contributions of 11 to 13 percent of salary a year.

In his own recent critique of the defined contribution approach, Comptroller DiNapoli cited estimates that 401(k) accounts lost \$1 trillion during the recession. He did not, however, note that the state pension fund all by itself lost \$40 billion in fiscal 2007-08 alone. Nor did he acknowledge that during his first four years as comptroller, a period in which NYSLRS counted on earning an average of close to 8 percent a year, its actual returns have averaged 2.2 percent -- which is why the taxpayers are being forced to kick in much more. This loss, I should point out, does not mean that our present comptroller is doing a bad job of investing, which is an entirely separate issue. All public pension plans have underperformed financially during this period. It simply underscores the risks and uncertainties borne by taxpayers under your current approach.

Again, the best approach would be to break, fully and finally, with the defined benefit plan, at least for general civilian employees of government, and to substitute a defined contribution plan for all new hires. The SUNY option alone would provide the vast majority of public employees with a retirement benefit far exceeding the amounts available to the vast majority of their counterparts in the private sector - not including Social Security benefits. The next best reform would be a hybrid option offering a

minimal "safety net" defined benefit plan and a defined contribution account – an approach now being pursued by California Gov. Jerry Brown, inspired in part by a recent reform enacted in Rhode Island.

Those who prefer to stay within the constraints of the governor's plan -- preserving a full defined-benefit option alongside a defined contribution plan -- should at a minimum consider several basic enhancements:

1. Require a larger contribution to the defined contribution option. The governor's proposal would set aside a 4 percent employer contribution with no required employee match. An additional employer match of up to 3 percent would be available to those who choose to contribute 3 percent of their own, adding up to a total maximum contribution of 10 percent of salary (7 from the employer). Many young workers may, indeed, be attracted to that cheaper option. The Legislature, however, needs to balance the desirable outcome of expanded worker choice and flexibility against the need to promote retirement security. To tilt in the direction of the security, you should amend the governor's defined contribution plan to require a minimum 4 percent employee match at the outset, thus creating a minimum savings of 8 percent of salary. Offer an additional 3 percent match to employees who contribute an additional 2 percent of their own. This would bring the maximum contribution to 13 percent – 7 percent from employers, 6 percent from employees – matching the level of savings available under the current SUNY system, but at a cost to employers (i.e., taxpayers) that is lower than current Tier 5 "normal" rates.
2. Bar elected officials and political appointees from any defined benefit plan – to remove the inherent biases and conflicts created by the current system.
3. Insist on greater transparency in pension accounting, so New Yorkers can finally have a better idea of the true costs of these benefits. This would include the requirement that the comptroller and other pension fund managers report funded status based on the unsmoothed, fair market value of their investments; that employers be provided with a periodically updated, projected range of future contributions out 10 years; that pension benefit cash flows be projected at least 20 years into the future; and that the current valuations of investment portfolios be reported on a quarterly basis.

Proponents of the *status quo* argue, correctly, that it provides employees with the greater retirement security. But it's time to recognize that security comes at a cost – a cost borne by current and future taxpayers, a cost our current system does not even fully measure or acknowledge. The financial security of employees alone should not be the sole concern here. You also need to be concerned, above all, with improving the stability, predictability, affordability and sustainability of public finances.

The question before you is whether one group of New Yorkers should remain able to retire early, and to receive entitled to constitutionally guaranteed incomes far in excess of what is available to the vast majority of New Yorkers, merely because they happen to work for government.