

BACKGROUND

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Nine Fallacies Used to Defend Public-Sector Pensions

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Abstract

Public pensions require fundamental reform, but defenders of the current system have advanced arguments that do not reflect sound economic thinking. These public-pension fallacies endure in political debates, even as finance economists have roundly rejected them. This Backgrounder addresses nine of the most common fallacies promulgated by defenders of public pensions—everything from the belief that governments can ignore investment risk to the idea that major “transition costs” prevent reform—and concisely explains why economists find each argument so unpersuasive. Correcting these fallacies will improve public discourse on the pension issue and remove an impediment to reform.

The generosity of retirement benefits for government employees has become a major political issue, as policymakers at all levels of government struggle with budget deficits in the midst of a weak economy. Government employees do enjoy retirement benefits that are often several times greater than the retirement benefits of comparable private-sector workers.¹ This imbalance contributes to the overcompensation of public workers in many municipalities and puts unnecessary strain on government budgets.

Public-sector retirement benefits require fundamental reform, but defenders of the current system have argued vociferously against any major changes. Defenders claim that retirement benefits are not actually generous, or that paying for the benefits is much easier than economists claim. These arguments are misleading and inconsistent with standard financial economics. Nevertheless, they frequently appear as talking points in publications from public-sector unions, pension administrators, and affiliated advocacy groups and think tanks.

This *Backgrounder* addresses nine of the most common fallacies promulgated by defenders of public-sector retirement benefits, concisely

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explaining why economists find each argument so unpersuasive. Sound economic arguments will hopefully eliminate these fallacies as obstacles to public-pension reform.

Background on Public Pensions

About 86 percent of full-time state and local government workers are enrolled in a defined-benefit (DB) retirement plan.² A DB plan is a traditional pension. Participants receive a regular monthly or weekly check—the value of which is determined by past wages and tenure—paid from retirement until death.

State and local DB plans for government employees (“public pensions”) are designed to be fully funded, meaning plan administrators set aside sufficient money each year to eventually pay the future pension benefits that active workers earn (or “accrue”) in that year. Administrators put these annual pension contributions into an investment fund. The combination of the annual contribution and the interest earned on that contribution is then supposed to pay for the benefits that current public workers have earned and will collect in the future.

In contrast with the public sector, the predominant retirement benefit now provided by private-sector employers is a defined-contribution (DC) plan, such as a 401(k) or 403(b) account. A DC plan is an account owned and managed by an individual worker. Many employers who offer DC plans make regular contributions

to DC accounts as part of their employee benefits program. No contribution is required, however, and no specific benefit is guaranteed.

Primarily because DB benefits are guaranteed to workers while DC benefits are not, public-sector retirement benefits are almost always more generous than those of comparable private-sector workers. Although that fact is widely acknowledged, defenders of public pensions have advanced fallacious arguments that downplay the generosity and cost of the plans.

Fallacy 1: The average pension payment is a good indicator of the generosity of the plan’s benefits.

Public-sector advocates often cite the average benefit paid out by a public pension, which can appear modest in comparison to what a private-sector worker might expect to receive in retirement after a lifetime of work.

But the average payment to current retirees actually provides little information about pension generosity. Included in the average are workers who had only short careers in public service and may have accrued retirement benefits elsewhere. If a worker is employed at three different companies over the course of his career, for example, he would not expect each individual company to provide for his entire retirement. The combined retirement benefits would hopefully be sufficient, but no individual period of employment

would be expected to provide the full amount. Similarly, a worker employed in the public sector for only a few years would not earn a full pension from the government, nor would anyone expect him to.

Another problem with citing average pension payments is that they necessarily include only current retirees. As pensions are made more generous over time, payments to older retirees drag down the average. A state government could theoretically double the promised benefits for incoming workers without the average pension payment reflecting that change at all.

Here is a real-world example of how misleading raw averages can be: The Teachers’ Retirement System (TRS) in Illinois insists that the average teacher’s DB pension “cannot qualify as ‘too generous,’” since it is only around \$46,000 per year.³ One might assume, based on the TRS statement, that the average Illinois teacher who retires after a full career will collect \$46,000 per year in pension benefits. Not so. The \$46,000 average includes benefits paid to teachers who worked only part of their careers in public schools.

Consider instead the pension payments to full-career public workers who recently retired. The 2011 TRS report shows that the average teacher who retired in the previous fiscal year after 35 to 39 years of service collects a pension benefit of \$68,496 per year, plus annual cost-of-living adjustments.⁴

1. Jason Richwine, “The Real Cost of Public Pensions,” Heritage Foundation *Backgrounder* No. 2694, May 31, 2012, <http://www.heritage.org/research/reports/2012/05/the-real-cost-of-public-pensions>.
2. Bureau of Labor Statistics, “Employee Benefits Survey—Retirement Benefits: Access, Participation, and Take-Up Rates,” March 2012, Table 2, <http://www.bls.gov/ncs/ebs/benefits/2012/ownership/govt/table02a.htm> (accessed January 29, 2013).
3. Teachers’ Retirement System of the State of Illinois, “Teacher Pensions Are Too ‘Generous,’” 2012, http://trs.illinois.gov/subsections/press/FinancialMatters_Investments.htm#teacherpensions (accessed January 29, 2013).
4. Teachers’ Retirement System of the State of Illinois, “Comprehensive Annual Financial Report for Fiscal Year Ending June 30, 2011,” December 2011, p. 117, <http://trs.illinois.gov/subsections/pubs/cafr/fy11/fy11cafr.pdf> (accessed January 29, 2013).

Fallacy 2: The cost of a public-pension plan is equal to whatever the government contributes to the pension fund each year.

A recent series of papers from government-oriented and labor-oriented think tanks have equated the total cost of a DB pension with whatever amounts that states and local governments contribute to their pension funds each year.⁵ But the employer set-aside for DB pension funding is not the same as the cost of the benefit, for several reasons.

First, pension set-asides include payments to fund benefits accruing in the current year, as well as payments toward unfunded liabilities from prior years. Only the former category should be counted as the cost of current compensation.

Second, because pensions are guaranteed by state law (and often by state constitutions), promised benefits must be paid at retirement regardless of how the employer has prepared for the expense. In lean times, states can reduce or skip their annual pension funding entirely, even as promised benefits stay the same. Claiming that a state's annual pension contribution is equivalent to the cost of pension benefits implies that benefits decrease drastically when states do not make their required contributions. In reality, the promised benefits are not

changing at all—states are simply writing IOUs to their pension funds.

Third, the calculated cost of pensions each year depends crucially on assumptions about the rate of return on the plan's investments. As discussed below, the higher the employer assumes the rate of return to be, the lower the annual set-asides for DB pensions need to be, even as the actual retirement benefit to workers stays at the same guaranteed level. In other words, employers can reduce their required contributions simply by assuming a higher rate of return on their investments. Of course, the employer liability and the employee benefit stay the same no matter what rate of return is assumed.

Despite the variability in rate-of-return assumptions across public plans, they are all too high for purposes of calculating pension costs. (See Fallacy 3.) Due in large part to that faulty accounting, the employer contribution can be a dramatic underestimate of pension costs. For instance, a recent analysis of public-sector compensation in New Jersey, published by the Economic Policy Institute,⁶ reported that public employees in New Jersey received pension-related compensation equal to 10.9 percent of their wages in 2009. However, the 10.9 percent figure merely reflects New Jersey's annual contribution to its

pension plan, without regard to the actual benefits that the state's public workers accrued that year. The real cost in 2009 was roughly 34 percent of wages.⁷

Fallacy 3: Public-pension plans can “assume away” risk because governments are long-lived.

A central problem with pension accounting in the public sector is the rate-of-return assumption on plan investments. When calculating the year-to-year cost of new benefits accrued by workers, plan administrators assume that their investments will achieve the “expected” (or target) rate of return, usually in the 7.5 percent to 8 percent range.

Much to the chagrin of finance economists, this cost calculation ignores the risk associated with plan investments. Pension funds *might* achieve 8 percent average returns, but they must pay their promised pension benefits regardless. This guarantee—that benefits will be paid even if the plan's investments do not generate the predicted returns—is not free. It must be incorporated into the calculated cost of public-pension plans. Finance economists do this by discounting (reducing the value of) future pension liabilities using a risk-adjusted rate of return (usually around 3 percent to 5 percent) rather than the expected rate of return

5. See, for example, Keith A. Bender and John S. Heywood, “Out of Balance,” Center for State and Local Government Excellence, April 2010, <http://www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7B03E820E8-FOF9-472F-98E2-FOAE1166D116%7D.PDF> (accessed January 29, 2013); John Schmitt, “The Benefits of State and Local Government Employees,” Center for Economic and Policy Research, May 2010, <http://www.cepr.net/documents/publications/benefits-state-local-2010-04.pdf> (accessed January 29, 2013); Sylvia A. Allegretto and Jeffrey Keefe, “The Truth About Public Employees in California: They Are Neither Overpaid Nor Overcompensated,” Center on Wage and Employment Dynamics *Policy Brief*, October 2010, <http://www.irle.berkeley.edu/cwed/wp/2010-03.pdf> (accessed January 29, 2013); and Jeffrey Keefe, “Debunking the Myth of the Overcompensated Public Employee,” Economic Policy Institute *Briefing Paper* No. 276, September 15, 2010, http://epi.3cdn.net/8808ae41b085032c0b_8um6bh5ty.pdf (accessed January 29, 2013).
6. Jeffrey H. Keefe, “Are New Jersey Public Employees Overpaid?” Economic Policy Institute *Briefing Paper* No. 270, July 30, 2010, <http://www.frenchesgrove.org/hypocrisy/nj%20workers.pdf> (accessed January 29, 2013).
7. Richwine, “The Real Cost of Public Pensions,” p. 6.

(around 8 percent). Such an approach is implicit in how private-sector pensions calculate their liabilities, as well as how public-employee plans in other countries do so.⁸

Adjusting for risk using the appropriate discount rate will often double or even triple the calculated cost of a pension plan compared to the cost claimed by public-pension administrators. Perhaps for this reason, administrators have advanced the fallacy that governments need not worry about investment risk. The argument goes like this: Since governments (unlike individuals) are multi-generational entities, year-to-year deviations from the expected return are likely to average out. This means that the risk of underperforming expectations in the long run approaches zero, and therefore there is no cost associated with insuring against sub-par returns.

This fallacy, sometimes referred to as the “time diversification” argument, is generated by a confused focus on the average yearly rate of return as opposed to what really counts—the cumulative return.⁹ Put simply, the risk of a sub-par average yearly return goes down over time, but the effect of such a low return—should it occur—is far more harmful to a portfolio when it occurs over a long period compared to a short period. Therefore, the risk of a large cumulative loss actually goes up the longer an investment is held.

A numerical example might help illustrate this point. Consider an investment with an expected annual return of 8 percent. Just as the proportion of “heads” will tend toward 50 percent the more often a fair coin is flipped, the average annual return will tend toward 8 percent on this investment over time. This means that the probability of an average annual return of only, say, 3 percent on this investment is certainly smaller after 10 years than after five years. More generally, the “variance” (meaning spread or dispersion) of the average yearly return becomes smaller the longer an investment is held. This is the good news about long-term investments.

The bad news is that if the average return *does* stay low, the magnitude of total losses is much greater over a long period than over a short one. Because annual returns compound, the effect of an average 3 percent return over, say, 10 years, has a much more negative impact on the cumulative return than a 3 percent average growth over, say, five years. Numerically, if the investment expected to earn an average of 8 percent per year instead yields only 3 percent annually over five years, then the investment would be 21 percent below the cumulative expected return. By contrast, averaging 3 percent over 10 years would leave the investment 38 percent lower than expected.¹⁰

Although lower-than-expected annual returns become less likely over time, the effect of compounding enhances the negative impact of such lower returns if they occur. The *cumulative* return on an investment therefore exhibits continued volatility over time, and governments cannot claim to eliminate risk on their own investments by being long-lived.

Fallacy 4: Advocates of risk-adjusted discounting are merely a niche group of contrarian economists.

Pension advocates often argue that the proper financial accounting discussed above is the product of a niche movement that mainstream finance experts do not endorse. The Texas Public Employee Retirement System, for example, claims that risk-free discounting for guaranteed liabilities is “only accepted by a handful of economists.”¹¹

That claim is false. The fact that the cost of a future liability depends on its risk rather than how it is financed goes back to the Modigliani–Miller theorem (or “capital structure irrelevance principle”), a foundational result in financial economics to which virtually every economist subscribes. In a 2012 poll, 38 of 39 leading economists agreed with this statement: “By discounting pension liabilities at high interest rates under government accounting standards, many U.S. state and

8. Aleksandar Andonov, Rob Bauer, and Martijn Cremers, “Pension Fund Asset Allocation and Liability Discount Rates: Camouflage and Reckless Risk Taking by U.S. Public Plans?” Social Science Research Network *Working Paper*, May 1, 2012, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2070054 (accessed January 29, 2013).
9. Academic economists have made this point in a variety of ways that are well summarized in Jack Duval, “The Myth of Time Diversification: Analysis, Application, and Incorrect New Account Forms,” *PIABA Bar Journal*, Spring 2006, <http://www.johnduval.com/MythofTime1.pdf> (accessed January 29, 2013).
10. Mathematically, $1 - 1.03^5/1.08^5 = 21$ percent after rounding, and $1 - 1.03^{10}/1.08^{10} = 38$ percent after rounding. The example in this paragraph is based on a similar one in Andrew G. Biggs, “Understanding the True Cost of State and Local Pensions,” *State Tax Notes*, February 13, 2012, <http://www.aei.org/article/economics/retirement/pensions/understanding-the-true-cost-of-state-and-local-pensions> (accessed January 29, 2013).
11. Texas Association of Public Employee Retirement Systems, “Debunking Myths about Texas Public Employee Pensions,” December 19, 2011, p. 3, <http://www.texpers.org/documents/Debunking-the-Arnold-Foundation-Report.pdf> (accessed January 29, 2013).

local governments understate their pension liabilities and the costs of providing pensions to public-sector workers.¹²

Discussing public pensions in 2008, then-vice chairman of the Federal Reserve Board Donald Kohn neatly summarized how economists view the discounting issue:

While economists are famous for disagreeing with each other on virtually every other conceivable issue, when it comes to this one there is no professional disagreement: The only appropriate way to calculate the present value of a very-low-risk liability is to use a very-low-risk discount rate.¹³

The defenders of public pension accounting methods are the embattled contrarians—not their critics in mainstream economics.

Fallacy 5: Critics of public-pension accounting assumptions are projecting low rates of return.

Because risk-adjusted accounting requires using a discount rate lower than the expected return on plan assets, defenders of public pensions often accuse critics of “projecting” historically low rates of return. The alleged projection is then slammed as unreasonable, since pensions have usually exceeded the risk-free rate of return in the past. But the reality is

that finance economists are making no projections whatsoever. A risk-adjusted discount rate simply incorporates the price of risk into cost estimates. It does not involve a prediction about whether the expected rate of return will be met.

Risk adjustment through a lower discount rate measures the actual amounts that financial markets charge to guarantee payment of a future liability. To illustrate, pensions could purchase financial products known as “put options” that would insure against the chance that their investments would fall short of their projected returns. A put option can make a pension truly fully funded, meaning that the taxpayer as well as pension participants would be protected against poor returns. But the cost of buying such an option would increase total costs to the same amount produced by discounting plan liabilities with a risk-adjusted rate.¹⁴

So why does the fallacy that economists are “projecting” low returns persist? Since public-pension administrators regard the choice of discount rate as a matter of guesswork regarding what the expected rate of return should be, they seem to assume that finance economists are engaging in similar guesswork when they recommend a risk-adjusted rate. But economists are uninterested, from a cost perspective, in the expected return on the assets used

to finance a liability. The guaranteed nature of pension benefits is what dictates the use of the risk-free rate.

Occasionally, pension advocates will advance an extreme version of this fallacy by describing the use of a risk-free discount rate as tantamount to projecting a “worst-case scenario” for the pension fund.¹⁵ Again, economists are not projecting any particular return. Furthermore, the low rates of return associated with guaranteed investments are certainly *not* the worst-case scenario for pension funds investing in risky assets. Millions of knowledgeable investors around the world hold long-term U.S. Treasury securities instead of riskier but higher-yielding investments, such as stocks. The low yields offered on safe investments reflect the returns that investors are willing to forgo in order to receive protection against the chance of doing even worse over the long term. The risk of a pension fund underperforming the alleged “worst-case scenario” is clearly real.

Fallacy 6: The investment returns earned by a pension fund pay for most pension benefits, so taxpayers are actually charged very little.

The National Association of State Retirement Administrators, a group that advocates for public pensions, states that only 28 percent of pension

12. The one economist who did not agree voted “uncertain” and commented that he was “not sure why they do that” in reference to GASB’s discount-rate policy. IGM Economic Experts Panel, “U.S. State Budgets,” October 1, 2012, http://www.igmchicago.org/igm-economic-experts-panel/poll-results?SurveyID=SV_87dIrlXQvZkFB1r (accessed January 29, 2013).

13. Donald L. Kohn, “Statement at the National Conference on Public Employee Retirement Systems Annual Conference,” New Orleans, Louisiana, May 20, 2008.

14. Andrew G. Biggs, “An Options Pricing Method for Calculating the Market Price of Public Sector Pension Liabilities,” *Public Budgeting & Finance*, Vol. 31, No. 3 (Fall 2011), pp. 94–118, <http://www.aei.org/files/2011/09/21/biggs-public%20budgeting%20and%20finance-options%20pricing%20paper.pdf> (accessed January 29, 2013).

15. For example: “In other words, reporting based on the riskless rate of investment return probably represents a ‘worse-than-worst-case’ scenario for future funding health of CalPERS.” California Legislative Analysts Office, “Summary of LAO Findings and Recommendations on the 2011–12 Budget,” January 24, 2011, <http://www.lao.ca.gov/laoapp/budgetlist/PublicSearch.aspx?Yr=2011&KeyCol=305> (accessed January 29, 2013).

benefits come from direct employer (taxpayer) contributions, while 12 percent come from public-employee contributions and 60 percent come from investment returns on those contributions.¹⁶

Some have misinterpreted this statement to mean that taxpayers fund only a quarter (or some other small fraction) of the cost of public pensions. The Service Employees International Union (SEIU), for example, writes the following in a “fact check” on public pensions: “The modest amount the average public worker takes home is covered largely through investment returns—not the emptying of taxpayers’ pockets.”¹⁷

The fallacy here lies in thinking that investment returns are somehow free. When people make investments, they forgo the opportunity to consume their money now in exchange for additional money to consume later. For that reason, the pension benefits paid from interest on taxpayer investments represent an additional component of taxpayer cost. The idea that free benefits somehow emanate from pension funds is not plausible, yet that is what SEIU and others are claiming when they advance the investment-earnings fallacy.

If one wants to know the actual fraction of public-pension costs for which taxpayers are responsible, the appropriate number is the proportion

of the risk-adjusted “normal cost” (the cost of benefits accruing each year) that is not covered by employee contributions. For public-school teachers in 2009, to use one example, that number was about 84 percent.¹⁸

Fallacy 7: Public pensions are not overly generous because they are simply deferred compensation.

Pension benefits are a form of deferred compensation, which is money that employees earn while working but collect at a later date. Some public-pension advocates have used this seemingly innocuous fact as a defense of pension generosity. The argument starts with the observation that pensions are not just a bonus or gift, and that reducing pension generosity is a reduction in compensation for public employees.¹⁹

This view is correct, but it is merely a recitation of the fact that pensions are part of compensation. The fallacy occurs when advocates go on to claim that the level of pension benefits is justifiable simply because these benefits are deferred wages. This is akin to saying that all wages paid to public employees, no matter how generous, can never be excessive. In reality, the generosity of pensions should be subject to as much public scrutiny as wages, health insurance, or any other form of employee compensation.

The fallacy also sometimes surfaces in the context of pension “pick-ups” by public employers. Both employers and employees generally make contributions to public-pension funds, but governments will sometimes pick-up (pay for) the employee contribution. This pick-up obviously comes at a cost to taxpayers.

Defenders of pick-ups argue that when an employer decides to pay the employee contribution, it effectively grants public workers a salary increase, and then takes that salary increase and puts it in the pension fund as deferred compensation. So the pick-up does not cost any extra, as this reasoning goes, because the salary increase has already been negotiated and agreed upon. Again, however, thinking of a pension pick-up as a form of deferred compensation does not at all justify the compensation itself. Yes, pensions are a form of employee compensation, but any compensation—regardless of when it is paid or what form it takes—can be excessive.

Fallacy 8: Generous pensions are necessary because some government employees do not participate in Social Security.

About 28 percent of state and local government employees do not participate in the Social Security system.²⁰ Because these “non-covered”

16. “State and Local Government Spending on Public Employee Retirement Systems,” National Association of State Retirement Administrators *Issue Brief*, August 2012, p. 2, <http://www.nasra.org/resources/NASRACostsBrief1202.pdf> (accessed January 29, 2013).

17. The “modest amount” referred to in the quote is the average pension payment (see Fallacy 1 discussed above). “Fact Check on Public Employees’ Pensions,” Service Employees International Union, <http://www.seiu.org/a/publicservices/fact-check-on-public-sector-pensions.php> (accessed January 29, 2013).

18. Jason Richwine and Andrew G. Biggs, “Assessing the Compensation of Public-School Teachers,” Heritage Foundation *Center for Data Analysis Report* No. 11-03, November 1, 2011, p. 15, <http://www.heritage.org/research/reports/2011/10/assessing-the-compensation-of-public-school-teachers>.

19. David Cay Johnston, “Really Bad Reporting in Wisconsin: Who ‘Contributes’ to Public Workers’ Pensions?” *TaxAnalysts.com*, February 24, 2011, <http://tax.com/taxcom/taxblog.nsf/Permalink/UBEN-8EDJYS?OpenDocument> (accessed January 29, 2013).

20. Dawn Nuschler, Alison M. Shelton, and John J. Topoleski, “Social Security: Mandatory Coverage of New State and Local Government Employees,” Congressional Research Service *Report for Congress* No. R41936, July 25, 2011, Table 1, <http://www.nasra.org/resources/CRS%202011%20Report.pdf> (accessed January 29, 2013).

workers do not accrue Social Security benefits for retirement, public-sector advocates often claim that generous pensions are necessary for this group to make up the difference.

Like many public-pension fallacies, however, this claim overlooks half of the picture. Non-covered public workers do not receive Social Security benefits—and they do not pay Social Security taxes either.

Whether Social Security is a good deal for a given set of workers depends on how their eventual benefits compare to the contributions they make via payroll taxes. For low-income workers, Social Security generally pays a rate of return in excess of what participants could receive by investing in other safe assets, such as government bonds. Put more simply, most low-income workers will receive more in Social Security benefits than they will pay in Social Security taxes. For middle-income and upper-income taxpayers, however, Social Security is usually not a good deal. These workers could have more money for retirement just by investing their payroll taxes in safe, low-returning assets rather than paying into the Social Security system.

Since most public employees fall into the middle-income range, it is generally a *benefit* for them to be exempt from participating in Social Security. Instead of contributing to

Social Security, they contribute to a public pension where benefits per dollar of contributions are much greater.²¹ There is no reason why the retirement benefits that non-covered public workers receive from their employer should be especially generous given their non-participation in Social Security. If anything, the benefits should be less generous.

Fallacy 9: Closing a public pension carries major transition costs.

Some pension reformers have advocated closing traditional DB plans for public employees and replacing them with either a 401(k)-style DC plan or a “cash balance” plan, which is a DB plan with some DC-like features. While such a policy change certainly involves difficult considerations and trade-offs, defenders of traditional pensions have alleged that the mere act of closing a DB plan generates major transition costs. The implication is that fundamental reform is too costly in the short term even if the current system is sub-optimal.

But the claim that the structure of DB plans makes them inherently costly to close is a fallacy. These claims take different forms. For example, it is often stated that closing a DB plan will end the plan’s long-run time horizon, forcing the fund to reallocate toward safer investments

to guarantee its remaining obligations.²² Since safer assets offer lower expected returns than risky assets, the full difference between these returns is alleged to be a transition cost. But, as discussed in Fallacy 3, a longer time horizon does not reduce risk in the first place. The alleged cost saving that pensions obtain from holding risky assets rather than safer assets is largely illusory, so reallocating toward safer assets should not add any major costs.

Another frequent claim is that the Governmental Accounting Standards Board (GASB) requires a pension’s “unfunded liability” (meaning accrued benefits for which administrators have not yet set aside money) to be paid off more quickly if the plan is closed.²³ The greater the unfunded liability, according to this claim, the greater the burden on states suddenly facing accelerated payments on that debt. Ironically, this would mean that the most badly managed plans have the strongest case for staying open.

But, as University of Arkansas economist Robert Costrell has demonstrated, pension plans are not bound by GASB funding rules, nor is the acceleration of debt payments a sensible rule in the first place.²⁴ Governments can continue to pay off unfunded liabilities on the same payment schedule even if they close their DB plans.

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21. Neither Social Security nor pension benefits are determined by any specific investment return, of course. But since pension administrators assume that their funds will earn a rate of return around 8 percent to cover guaranteed benefits, the average pension participant receives, in a sense, a guaranteed average return of 8 percent on his contributions. As noted in the text, the average middle-income to upper-income Social Security participant receives an effective annual return over his lifetime that is lower even than that of U.S. Treasuries.
 22. For example, the Teacher Retirement System of Texas warns that closing the DB plan will increase costs by “reducing the amount of risk (volatility) that can be borne by the investment portfolio, and pushing the trust towards a more conservative asset allocation, which is expected to produce lower returns.” “Pension Benefit Design Study,” Teacher Retirement System of Texas, September 1, 2012, p. 31, http://www.trts.state.tx.us/about/documents/pension_study_benefit_design.pdf (accessed January 29, 2013).
 23. For example, “The Impact of Closing the Defined Benefit Plan at CalPERS,” California Public Employees’ Retirement System, March 2011, pp. 5–6, <http://www.calpers.ca.gov/eip-docs/closing-impact.pdf> (accessed January 29, 2013).
 24. Robert M. Costrell, “GASB Won’t Let Me’—A False Objection to Pension Reform,” Laura and John Arnold Foundation, May 2012, <http://www.arnoldfoundation.org/sites/default/files/pdf/A9R4D8C.pdf> (accessed January 29, 2013).

Costrell gives several examples of states doing exactly that. In 2011, the State of Utah closed its traditional DB plan to new workers and created a new system in which state workers could choose a pure DC plan or a DB–DC hybrid. Utah did *not* alter its amortization schedule for unfunded liabilities as a result of this switch. In 2006, Alaska went further than Utah in putting all incoming state workers on a pure DC plan. After a year of initial confusion caused by GASB rules, the state reverted without incident to the amortization method it had used prior to the switch.²⁵

Conclusion

With public-pension costs straining the budgets of state and local governments, fundamental reform of the way in which public employees receive retirement benefits is needed. Unfortunately, defenders of the current system have advanced arguments that do not reflect sound economic thinking. These public-pension fallacies are so often repeated—in press releases, talking points, letters to the editor, debates on radio and television, think tank reports, and even actuarial statements—that many seem to have become

conventional wisdom in some circles, even as finance economists roundly reject them. Correcting these fallacies will improve public discourse on pensions and remove an impediment to reform.

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25. More specifically, Alaska went back to calculating its amortization payments as a level percent of total payroll rather than the constant-dollar method supposedly required by GASB. Alaska did increase its actual payments toward the unfunded liability around that time, but this was due to past underfunding of the annual required contribution (ARC), not to a different method of calculating the ARC. See *ibid.*, pp. 26–29.