The Commonwealth's Pension System:

A Good Investment for Massachusetts

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Introduction

"Among those non-cash benefits being provided to employees by their employers, pension plans and the liabilities they generate seem to capture the greatest amount of interest and concern. The concern is expressed not only by those directly involved with a pension plan, the sponsoring entity and the beneficiaries of the plan, but the Federal Government, the media and the public at large."

Massachusetts Retirement Law Commission
July 1982

As the Baby Boomer generation approaches retirement age, the goal of "retirement security" is the subject of increasingly more research, discussion and concern. Given the ongoing threat to traditional pension benefits and growing concerns regarding the financial solvency of the Social Security system, more Americans are wondering whether they will be able to enjoy the retirement lifestyle that their parents have experienced.

According to a recent study conducted by the Government Accountability Office (GAO), "(f)or the first time since 1934, net national saving declined to less than 1 percent of GDP and the personal savings rate was slightly negative in 2005."[i]

"(t)here is little rationale for requiring future taxpayers to pay for services provided to current citizens by present state and local workers. Under a funded system, the cost of benefits for present active employees will be borne by present taxpayers and will not become a liability to future taxpayers."

The Employee Benefit Research Institute (EBRI), a nationally-recognized source of independent retirement research, recently published the findings of its 16th annual Retirement Confidence Survey® (RCS). According to their survey, "(m)ore than half of workers saving for retirement report savings and investments (not including the value of their primary residence or any defined benefit plans) of less than $50,000 (52%). However, the majority of workers who have not put money aside for retirement have little in savings at all: Three-quarters of these workers say their assets total less than $10,000 (75%)."[ii]

It's against this backdrop – an aging population, an underfunded Social Security system, negative personal savings rates, and insufficient retirement savings – that we will discuss the current state of the Massachusetts public pension system. Although the Commonwealth's retirement system may continue to generate just as much interest and concern as it did more than 24 years ago when the Retirement Law Commission recommended a number of funding options, the system has proven to be a good investment for Massachusetts taxpayers, a reliable source of economic activity throughout the Commonwealth and a program that guarantees the retirement security of nearly 500,000 workers and retirees.

Section I. Keeping Promises: Funding Pension Benefits

The Massachusetts Retirement System is financially sound.

It's been 30 years since the Retirement Law Commission and the Funding Advisory Committee recommended that Massachusetts abandon its pay-as-you-go system for funding the Commonwealth's public retirement systems. At that time, the systems' reserves amounted to $2 billion – accumulated completely from employee contributions. In its place they recommended that Massachusetts follow the example of the 49 other states and adopt a program that would pre-fund retirement benefits as they are earned by active employees and that would amortize the unfunded accrued liability over a period of 40 years.

At the time, the Commission recognized the importance of preserving intergenerational equity in the way in which the plan is funded. Its report concluded, "(t)here is little rationale for requiring future taxpayers to pay for services provided to current citizens by present state and local workers. Under a funded system, the cost of benefits for present active employees will be borne by present taxpayers and will not become a liability to future taxpayers."[iii]

The Commission also recognized that by investing increasing pension reserves, more and more future benefits would be paid from investment income as opposed to either employee or employer (taxpayer) contributions.

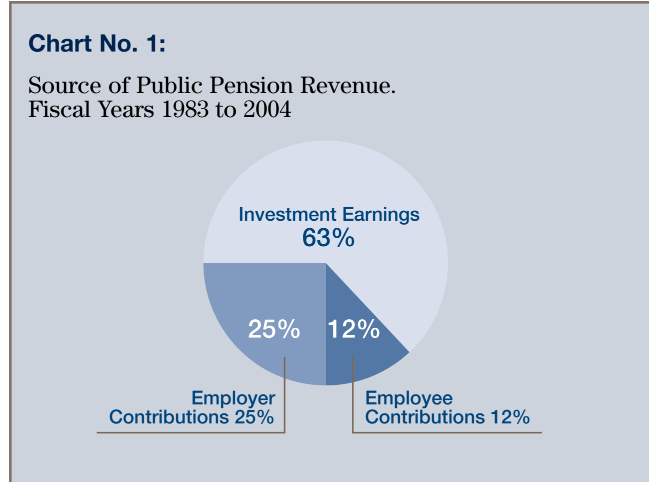

Chart No. 1:

Source of Public Pension Revenue.
Fiscal Years 1983 to 2004

Although it would take Massachusetts more than 10 years to ultimately embrace the fundamental funding principles that were recommended in 1976, the wisdom of those recommendations has been borne out in the Commonwealth and around the nation. The National Association of State Retirement Administrators (NASRA) estimates that nationally "employer (taxpayer) contributions to state and local pension systems over the last two decades have made up only one-fourth of total public pension revenue."[iv] They also point out that this ratio is improving – with taxpayer contributions accounting for only 15% of system income in 2004. Chart No. 1 illustrates the source of public pension revenue from 1983 through 2004. According to the U. S. Department of Commerce, from 1983 through 2002, nationally state and local defined benefit plan investments earned $1.65 trillion, substantially reducing the need for additional employer contributions and taxpayer revenues.[v]

The Massachusetts Pension Reserve Investment Trust (PRIT) Fund was established in December 1983 by Chapter 661 of the Act of 1983 to accumulate assets to reduce the Commonwealth's unfunded pension liability and to assist any local retirement system that chose to participate in the fund. On January 1, 1997, the PRIT Fund merged with the Massachusetts State Teachers' and Employees' Retirement Systems (MASTERS) Trust thereby giving the Pension Reserve Investment Management (PRIM) Board investment responsibility for all of the assets of the State Employees' Retirement System and the Massachusetts Teachers' Retirement System.

Over the last 21 years, the PRIT Fund has grown from $597 million, as of June 30, 1985, to $41.9 billion as of June 30, 2006.

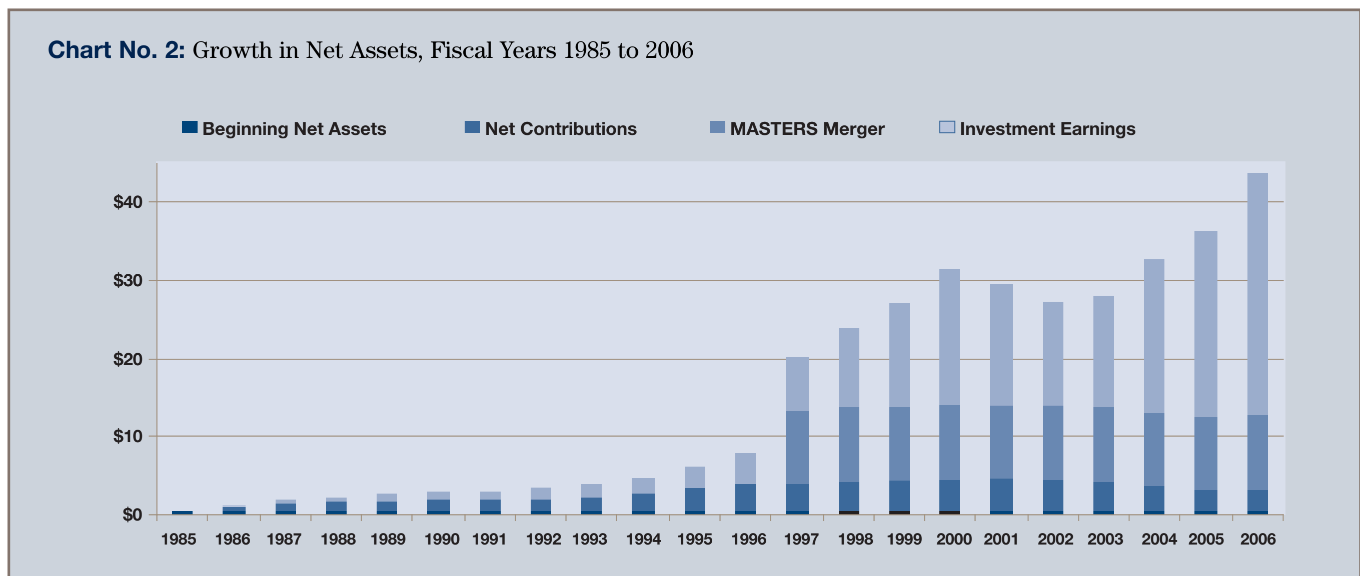

Chart No. 2: Growth in Net Assets, Fiscal Years 1985 to 2006

According to its Annual Financial Report as of June 30, 2005, 81% of the PRIT Fund's income was realized from investment income. Chart No. 2 illustrates the impact of strong investment performance on the current value of the PRIT Fund.

When the Retirement Law Commission issued its 1976 report, it projected that the Commonwealth's pay-as-you-go pension costs would grow from 12.1% to 31.9% of payroll by 1993 and would continue to rise thereafter. The funding program that they recommended would see pension contributions level off at 27.2% of payroll in the funding schedule's 23rd year.[vi]

The Commonwealth's fiscal year 2006 pension cost is $1.143 billion for the state employees' and teachers' retirement systems; however, as a result of pre-funding for current employees, superior investment returns and increasing employee contributions, that amount continues to represent approximately 12% of the two systems' combined payrolls. This amount, which according to PERAC data is consistent with the statewide average for all State and local plans, is less than half of the 27.2% of payroll that the Retirement Law Commission originally projected.

To state the Commonwealth's overall funding progress in another way, the total assets of Massachusetts State and local pension plans have grown from $2 billion as reported by the Retirement Law Commission in 1976 to more than $51 billion today.

The Massachusetts pension system is a good value for state and local taxpayers.

Unlike most private sector defined benefit retirement plans, Massachusetts public employees have contributed to their pension plans since 1945. Chart No. 3 illustrates current employee contribution rates.

In its recent report, the Blue Ribbon Panel on Massachusetts Public Employees' Pension Classification System indicated that the current "public employee retirement system provides appropriate benefits for long-service employees and is on a path toward adequate funding."[vii] In addition, the panel makes it clear that Massachusetts public employees are paying for a significant portion of their ultimate pension benefit. As more members who contribute at the rate of 5 or 7% are replaced by members contributing 9, 11 and 12%, the employer (taxpayer) cost will be reduced even more.

Chart No. 3:
Massachusetts Employee Contribution Rates as a Percentage of Pay

Date of Hire	Contribution Rate
Prior to 1945	No contribution
1945-74	5%
1975-78	7%
1979-83	7% + 2% over $30,000
1984-96	8% + 2% over $30,000
1996-Present	9% + 2% over $30,000
Teachers – Retirement Plus	11%
State Police hired after July 1, 1996	12%

Chart No. 4:
Employee contributions as a percentage of total normal cost for the State Retirement System as of January 1, 2006

Group	Total Normal Cost	Expected Employee Contribution	Employer Normal Cost	Employee Contributions as a Percentage of Total Normal Cost
Group 1 (Teachers and General Employees)	11.2%	8.3%	2.9%	74.1%
Group 2 (Hazardous Duty)	12.7%	8.1%	4.6%	63.8%
Group 3 (State Police)	21.2%	8.6%	12.6%	40.6%
Group 4 (Public Safety)	19.8%	8.9%	10.9%	67.5%
All	12.3%	8.3%	4.0%	67.5%

Source: Report of the Blue Ribbon Panel on Massachusetts Public Employees' Pension Classified System.

The panel's report contains an analysis of employee contributions as a percentage of total normal cost (amount necessary to pre-fund benefits as they accrue) for the State Retirement System. Chart No. 4 presents the results of their analysis.

Since over three-quarters (78%) of the members of the State Retirement System are classified in Group 1, it's obvious that the vast majority of state employees will pay (contributions + investment income) nearly 75% of the cost of their pensions. In fact, state police officers – representing only approximately 2% of the system's membership – represent the only group that will actually pay less than half (40.6%) of their pension funding cost.

A recent report by the Pioneer Institute makes the point even more directly. According to their report, "(b)ecause the contribution rates are higher for new employees, in some cases the state will actually pay out less in pension benefits than it receives in contributions and investment, making a profit."[viii]

Further, "(t)he expected cost to the state of eventually providing retirement benefits for all current employees is less than 3 percent of payroll. This figure includes the state's share of the cost for many employees who were hired before 1996 and make smaller contributions. Barring any fundamental changes to the retirement system, as these older workers retire and are replaced with employees who contribute at a higher rate, the state's share of pension costs will decline over the next 20 years."

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The Commonwealth is funding its pension liabilities.

Massachusetts began this journey with only $2 billion in reserve funds and was the 50th state to adopt a funding program designed to amortize past liabilities while pre-funding benefits for current employees. Although Massachusetts still has some work to do, it's important to recognize the tremendous progress that has been achieved.

In 1988, following a series of actuarial studies and a debate that spanned several legislative sessions, the Commonwealth began the 40-year amortization program initially proposed in 1976. Recognizing the tremendous progress that had been achieved, the Commonwealth's schedule was shortened by 10 years in 1998. A subsequent State budget crisis resulted in the schedule being extended by five years. However, notwithstanding an attempt by the current Administration to extend the schedule out to its original 2028 deadline, the Commonwealth remains five years ahead of its original funding goal.

The system's unfunded accrued liability is often compared to a home mortgage. Although the total amount due is certainly important, the ability to pay the required installments is actually the more appropriate measure of the plan's fiscal soundness. Like a mortgage, the Commonwealth was able to refinance the debt to shorten the term following a number of good years while conversely extending the obligation in the years that weren't so good. In each case, these decisions were made with an eye toward maintaining the Commonwealth's commitment to the plan while at the same time responding to the fiscal realities of time. Used prudently, the ability to have this kind of flexibility is a major attribute of the defined benefit retirement model.

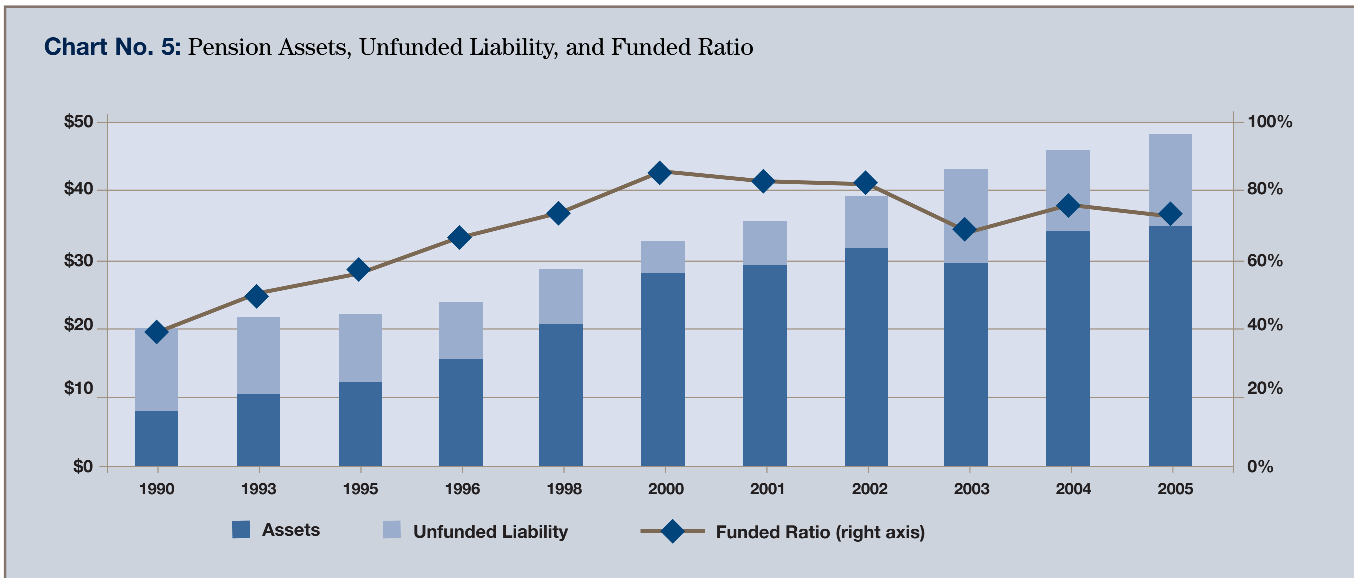
A $145 Million Promise

In 2003, Governor Romney signed a budget that underfunded the state employees and teachers' pension fund by $145 million. Instead, the budget promised income from the transfer and ultimate sale of the John B. Hynes Convention Center and the Boston Common Garage. The transfer never took place.

While every public employee continues to meet his/her commitment to the pension fund, that one decision has cost the system $xxx, based on the PRIM Board's performance to date.

The Pioneer Institute prepared the following chart to illustrate the change in pension assets, unfunded liability and the funding ratio from 1990 through 2005. Although it demonstrates the fluctuation in the Commonwealth's assets and liabilities, it's hard to ignore the dramatic progress that has occurred over this 15 year period. As the Pioneer Institute correctly points out, "the unfunded liability today stems primarily from the fact that for many years the state operated on a pay-as-you-go basis and didn't put aside money to cover future liabilities."[ix] When you combine this historic lack of pre-funding with the sustained underperformance of the investments in 2001-03, the systems' unfunded actuarial liability is understandable.

Chart No. 5: Pension Assets, Unfunded Liability, and Funded Ratio



Proponents of replacing the Commonwealth's defined benefit retirement system with a defined contribution plan use the costs associated with the current system's accrued liability to argue for fundamental systemic change. The unfunded accrued liability of the existing system, though, is the Commonwealth's responsibility regardless of any choices the Legislature makes. If the Governor and the Legislature were to abandon the current Massachusetts retirement plan tomorrow, every current employee would be entitled to participate in the existing plan until they retire. Only newly hired employees could be required to participate in a new plan. In fact, if the current plan were closed to new members - eliminating the flow of new contributions into the plan and ultimately forcing the use of a far more conservative investment strategy over the life of the plan – the actuarial accrued liability would grow and would inevitably lead to increased employer (taxpayer) contributions.

The Cost To Change

Before spending 'presumed savings' from a conversion to a defined contribution plan, perhaps someone should calculate the cost to convert to and to administer a defined contribution plan while at the same time maintaining the defined benefit program for current employees.

For example, it's been reported that Florida budgeted $55 million dollars just to educate employees about the new plan!

In response to California Governor Arnold Schwarzenegger's proposal to convert that state's defined benefit retirement systems to defined contribution plans, the Los Angeles County Employees Retirement Association (LACERA) estimated that the County's defined benefit plan contribution rate would increase by 3.66% if employees hired after July 1, 2007 were required to join a defined contribution plan. This would increase County (taxpayer) contributions to the closed plan by $206 million in 2008. While their report indicated that contributions would gradually decline over time, the County would have to wait until 2018 to see any savings.[x]

Section II. A Good Investment

The Massachusetts pension funds play an important role in the Commonwealth's economy.

In Section I, we discussed the impact that investment income has on the ability to fully fund the Commonwealth's public retirement system. We've also discussed how investment income helps to control the amount of taxpayer dollars that are necessary to fulfill important commitments state and local retirement plans have made to nearly 500,000 active and retired Massachusetts public workers.

In this section, we'll highlight how the Commonwealth's state and local retirement systems contribute to the larger Massachusetts economy. We'll also discuss how attacks on defined benefit retirement plans threaten to undermine this significant source of economic activity in Massachusetts and around the country.

Critics of public pension plans sometimes cast them as entitlement programs riddled with abuse and with liabilities spiraling out of control. However, in reality, these plans could easily be viewed as some of the Commonwealth's largest "employers" – providing a monthly payroll for nearly 180,000 retired Massachusetts public workers. Since the vast majority of these workers continue to live in Massachusetts, these dollars are reinvested in our economy on a daily basis.

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For example, in fiscal year 2006, Massachusetts taxpayers invested slightly more than $1.1 billion to fund the State Employees' Retirement System and the Massachusetts Teachers' Retirement Systems; however, at the same time those two systems were returning more than twice that amount to the Commonwealth's economy in the form of retirement benefits for up to 50,000 retired teachers and state employees. These dollars are used to pay taxes, to make mortgage or rent payments and to purchase a wide range of goods and services. In turn, these payments create jobs and generate additional economic activity.

On a statewide basis, Massachusetts state and local pension plans provide this monthly "payroll" for nearly 180,000 retired workers. Collectively, this represents the reinvestment of nearly $4 billion annually into the

Who pays for retirees without a pension?

It's frequently argued that the public sector could save money by abandoning pension promises – just like corporations in the private sector. But there's a fundamental difference. When a private corporation freezes its pension plan it also freezes its liabilities – the workers are left to fend for themselves. Who pays if those workers can't afford to care for themselves in retirement? Certainly not the corporation that abandoned its pension promise.

Retired workers who aren't able to care for themselves inevitably place a greater burden on public sector assistance programs. Regardless of the form – welfare assistance, subsidized public housing, fuel assistance, food stamps, or uninsured health care – taxpayers will pay.

So, for the public sector, isn't this a 'pay me now or pay me later' proposition? Or, given the economics of pre-funded pension benefits, isn't the real question: 'Pay me a little now or pay me a lot more later?'

Since public assistance programs are neither pre-funded nor offset by strong investment performance and since current Massachusetts public employees aren't protected by the Social Security safety-net available to private sector workers, it seems like a fiscally responsible pension program – one tested and proven by years of successful benefit payments – is a far better investment for Massachusetts.

Massachusetts economy. In a recent study conducted for the Texas Teachers' Retirement System (Texas TRS), it was determined that the more than $5 billion that Texas TRS retiree benefits paid on an annual basis generate significant economic activity in the state including some $9.872 billion in total spending and 72,014 permanent jobs.[xi]

According to the Texas study, "(f)or every dollar the State of Texas contributes to the TRS in an average year, the impact on spending totals some $7.85. When adjusted for the fiscal revenues which flow back to the State as a result of the outlays, every net dollar provided by the State results in $12.48 in aggregate expenditures." Although the magnitude will be different from one state to another, it's reasonable to assume that the payment of benefits in Massachusetts and every other state and local pension plan produce similar positive results.

The following chart provides a comparison of employer (taxpayer) contributions vs. annual benefit payroll for a random sample of Massachusetts local pension plans. These numbers are typical throughout the system.

Chart No. 6:
Annual Employer Contributions vs. Benefits Payroll

Retirement System	Employer Contribution	Benefits Payroll
Brockton	$10.3 million	$25.5 million
Dedham	$3.2 million	$5.3 million
Lynn	$18.2 million	$25.2 million
Marblehead	$2.2 million	$5.2 million
Newton	$10.6 million	$25.0 million
Quincy	$19.1 million	$33.9 million
Worcester	$23.3 million	$43.3 million

Source: PERAC Actuarial Valuations

Defined Benefit vs. Defined Contribution – Does It Matter?

In a word – yes.

A recent study conducted by Boston College's Center for Retirement Research compared returns of private retirement plans that hold a combined $8.4 trillion — $3.67 trillion in IRAs, $2.87 trillion in 401(k)s and similar "defined-contribution" plans, and $1.92 trillion held by traditional defined benefit pension plans. According to the study, 401(k) retirement-savings plans have underperformed traditional company pension plans by one percentage point a year and individual retirement accounts fared even worse.[xii]

Defined Contribution Savings Supplement – But Not Replace – Traditional Retirement Plans

Proponents of defined contribution savings plans are correct – employees should have access to voluntary tax-deferred savings vehicles to help save for retirement. And, most do.

State and local government employees in Massachusetts and nationally have access to 457 governmental deferred compensation plans and 403(b) annuities. Participation in these plans supplements a worker's pension benefit and provides a more portable benefit for short-term employees.

Proponents of converting traditional pension plans to defined contribution or 401(k)-like plans argue the workers want a more active role in managing their retirement assets; however, study after study suggests otherwise. A 2005 study conducted by Hewitt Associates found that only 2% of workers said they are very knowledgeable about investing, while half said they were "less than knowledgeable or not at all knowledgeable."

In the context of "retirement security," what's even worse is that according to a July '05 article in the *San Francisco Chronicle*, "45 percent of workers who left their jobs in 2004 cashed out 401(k)s, including 42.2 percent of people in their 40s."

Alicia H. Munnell, director of the Center for Retirement and one of the authors of the study reflected that a one percent difference isn't significant in any year; however, she added "this is every single year, and if that were true over a person's 40-year worklife, they would end up with 20 percent less at retirement."

Another example can be found in Nebraska. In 2000, the State reviewed its two defined contribution retirement plans for state and county workers and found that between 1983 and 1999 the defined contribution plans' investment returns averaged only 6%, compared with 11% for the state's defined benefit plans.xiii As a result, in 2002, the Nebraska legislature replaced the defined contribution plan with a hybrid plan that takes investment decisions out of the hands of employees and provides a guaranteed rate of return.

Pension Assets: A Resource for Massachusetts and the Nation

All Americans benefit from the pensions provided to public employees. "The $2.8 trillion held by public pension funds is a key source of liquidity and stability for the nation's financial markets," Keith Brainard, Research Director for the National Association of State Retirement Administrators, said.xiv "Pension assets are real, invested in stocks, bonds, real estate, venture capital, and other asset classes. Public pensions hold in trust more than 10 percent of the nation's corporate equities, and, as institutional investors, public pension funds are an important source of long-term, patient capital for the nation's publicly-traded companies." According to Mr. Brainard, "pension funds are also a key source of financing for venture capital, which represents the seeds of the nation's future economic growth and productivity gains."

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A review of the Commonwealth's experience reveals concrete examples of how defined benefit plan assets are strengthening the Massachusetts economy. For example, the PRIM Board has invested in the Access Capital Strategies Community Investment Fund (ACSCIF). ACSCIF only invests in fixed income investments that are guaranteed by U.S. Government agencies, Fannie Mae, Freddie Mac, or have AAA credit enhancements. The Fund fosters economic development in America's underserved communities. It can target its investment by income and geographic region, allowing investorsto pinpoint where their investments make a positive impact on the community. The fund has more than $133.7 million invested in Massachusetts, including:

- 1,188 home mortgages to low- and moderate-income homebuyers
- 415 affordable rental housing units, 8 small business loans
- 5 economic development loans
- $9.375 million loan to the Holyoke Community Health Center, helping it to add 300 new jobs

These investments are located in 13 counties and 249 cities and towns throughout the Commonwealth.[xv]

Investing in Massachusetts – A Local Example

The Essex Regional Retirement Board, like the PRIM Board and many other local pension systems, has targeted a percentage of its portfolio for Massachusetts-based initiatives.

In its case, Essex has invested in the Massachusetts Technology Development Corporation. This program provides initial investment capital for early-stage technology companies located in the Commonwealth. The MTDC has invested in many of the State's most promising new technology-based companies. These companies provide incalculable economic benefits that spread throughout the entire Massachusetts economy.

This is just one more example of how the current Massachusetts retirement system provides benefits far beyond the pensions paid to retired public workers.

A second example can be found in the PRIM Board's investment in the Intercontinental Real Estate Corporation Fund. Intercontinental targets new development projects and acquisitions of real property assets which require construction, rehabilitation, repositioning and financial restructuring. The fund currently holds two Massachusetts properties that are expected to provide future tax revenue and labor hours for the state. The following chart illustrates the impact on job creation as a result of a single Intercontinental project at Ten Faxon Avenue in Quincy, MA.

Chart No. 7:

Job Creation Matrix, Fund IV, Intercontinental Real Estate Corporation

State's ETI Program: Jobs Created

Project: Ten Faxon Avenue Quincy, MA	Total Union Hours Created	Total Project Hard Cost
	245,050	$38,215,000
By Trade	**Total Labor Hours**	**Total Labor Cost**
Laborers	32,500	$2,275,000
Carpenters	58,850	$4,119,500
Bricklayers	10,750	$752,500
Cement Finishers	4,100	$287,000
Teamsters	14,400	$1,008,000
Operating Engineers	11,200	$784,000
Ironworkers	27,000	$1,890,000
Roofers	2,100	$147,000
Glaziers	11,000	$770,000
Painters	6,800	$476,000
Elevator Constructors	4,800	$336,000
Plumbers	18,350	$1,284,500
Pipefitters	14,450	$1,011,500
Sheetmetal Workers	8,800	$616,000
Electricians	19,950	$1,396,500
Grand Total	**245,050**	**$17,153,500**

Source: PRIM ETI Quarterly Update for the Quarter Ended 6/30/06

These two examples are illustrative of countless investments that Massachusetts state and local retirement plans and other defined benefit plans have made throughout the nation. They demonstrate the larger impact that defined benefit plans have on the economy of Massachusetts and the nation.

Section III. A Strong Foundation for Retirement Security

When it comes to retirement security, Massachusetts keeps its promises!

Critics of the Massachusetts retirement system argue that it places an undue burden on taxpayers and is unfair to public employees. They question the financial security of state and local pension plans while trumpeting the success of the private sector 401(k) model, and they argue that public employees are more mobile and demand more portable retirement benefits. Finally, they suggest that public employees want to take a more active role in the management of their retirement assets.

To some, all of this sounds good – but there is little evidence to suggest that any of these assertions are correct. In fact, there's a lot of evidence to suggest that the opposite is true. This section will take a closer look at why a defined benefit retirement plan is a central ingredient to providing meaningful retirement security.

State and local pension systems have a contractual obligation to pay benefits promised to every public worker and they continue to do so every month.

The pensions of Massachusetts public workers are secure.

Massachusetts will absolutely keep its promises. State and local pension systems have a contractual obligation to pay benefits promised to every public worker[xvi] and they continue to do so every month.

In this regard, the Massachusetts commitment is completely analogous to the nation's other public sector retirement plans. "(P)ublic plans are backed by the full faith and credit of their sponsoring state and local governments, and public plan participants' accrued level of benefits and future accruals typically are protected by state constitutions, statutes, or case law, which prohibit the elimination of diminution of retirement benefits, according to testimony recently submitted to the U.S. House Committee on Education and the Workforce. "These constitutional and statutory protections provide greater security than are provided to private sector pension plans under the Employee Retirement Income Security Act (ERISA) and the Pension Benefit Guaranty Corporation."[xvii]

Implementing a private sector retirement program would be <u>more expensive for taxpayers</u> than maintaining the current Massachusetts retirement system.

According to data recently provided to the Massachusetts General Court's Joint Committee on Public Service by its Blue Ribbon Panel, a private sector employer contributes 6.2 percent to Social Security and typically pays 3 percent in the form of a 401(k) match on the employee's 6 percent contribution for a total employer cost of 9.2 percent of payroll.[xviii]

By comparison, the same report calculates the current employer cost for the Massachusetts State Employees' Retirement System to be 4 percent – with three-quarters of the plan's participants costing less than 3 percent and trending down.

In addition, according to National Association of State Retirement Administrators, the administrative cost of public defined benefit plans is substantially lower than for a typical defined contribution plan.

What do employees do when they have a choice?

Since public pension plans are typically protected by constitutional or contractual guarantees (as is the case in Massachusetts), some states have chosen to offer current workers optional defined contribution plans. Despite the fact that defined contribution plan proponents argue that workers are anxious to manage their own pension plans, the actual experience doesn't support that proposition.

According to an article published in *Governing Magazine*, three percent of employees covered by the DB plan elected to join the new DC plan in Florida, 6 percent in Michigan, and 2.5 percent in Ohio.

Most recently, West Virginia's state legislature passed a bill that allows teachers to abandon a defined contribution plan for a re-opened defined benefit program. The plan's actuary projects the change could save West Virginia taxpayers $1.8 billion over the next 30 years.

The median cost of a defined contribution plan is approximately 1.40%; the median cost of a statewide public pension benefit is approximately 0.30%.

A recent Massachusetts reform proposal suggests that the Commonwealth could mirror private sector benefits by simply implementing a 401(k)-like program with an employer match of between 2.5% and 4%. However, to be fair, it's important to remember that all private sector employees are also eligible for Social Security benefits.

Since Massachusetts public employees currently don't participate in the Social Security system, any proposal that claims to mirror the private sector must also provide Social Security benefits, which would cost employers an additional 6.2 percent of payroll. Absent these benefits, such a proposal would leave public workers without a retirement security safety net and with retirement benefits far below those provided by either the private or public sector.

any proposal that claims to mirror the private sector must also provide Social Security benefits

The Commonwealth's retirement plan provides disability and survivor benefits in addition to secure retirement income.

According to the U.S. Bureau of Labor Statistics, 97% of state and local government employees in defined benefit plans have disability coverage through the plan, and 93% have the option of electing joint and survivor benefits.xix Disability and survivor benefits are especially important for employees in hazardous occupations such as firefighters and police officers. Since defined contribution plan survivor benefits are limited to the participant's account balance, the death of any employee prior to retirement could easily leave his/her family in a financial crisis. An employer could attempt to replicate these benefits through commercial insurance; however, insurance would represent a higher cost alternative for employers, in part because the cost would include the insurer's profit margin.

Current retirement benefits enhance the Commonwealth's ability to attract qualified state and local government employees and to retain them throughout their careers.

According to the Diversified Investment Advisors' Report on Retirement Plans, most large employers see a tangible value in offering a defined benefit plan to their employees. Fifty eight percent of plan sponsors with 25,000 or more employees believe that their defined benefit plans have a major impact on employee retention.[xx]

Social Security and the Commonwealth

Federal, State and local Massachusetts public officials have historically opposed congressional attempts to mandate Social Security coverage on all State and local employees. The Massachusetts retirement system predates Social Security and evolved at a time when public employees were precluded from participating in the Social Security system.

Since the Social Security tax far exceeds the cost of the current pension plan for Massachusetts public employers, the Commonwealth's position has enjoyed broad bipartisan support.

According to a Cato Institute paper that examined the cost of Social Security vs. the Massachusetts Teachers' Retirement System, a Social Security benefit "is 43-75 percent less than the MTRS retirement benefit, depending on an individual's salary."

Social Security – higher costs for the Commonwealth's taxpayers and lower benefits for state and local public workers – is not a good investment for Massachusetts.

Since government is often unable to pay salaries that are competitive with the private sector, state and local governments must rely on other forms of compensation to compete for qualified workers. Key governmental service areas, such as education and public safety, require skilled and dedicated employees to work in positions involving high levels of stress or physical activity or both. Since individuals with the skills and temperament to take on these roles usually have other opportunities in the labor market, it's important that government employers offer defined benefit plans to reward long-term, dedicated service with a secure retirement.[xxi]

The Commonwealth's defined benefit retirement plans – when used responsibly – can help state and local governments manage their human resources by providing incentives that affect retirement decisions.

Although retirement system administration is typically independent from other state and local human resource functions, it's important that the Commonwealth's pension plan be viewed in the overall context of employee benefits. As a result, from time-to-time the inherent flexibility of defined benefit pension plan design and funding may be prudently used to address equally critical public policy needs.

A few examples include:

- In 1991, Governor William Weld proposed an early-retirement incentive plan for state workers. At the time he said, "(t)his plan is good for both the state and state employees. It will save money while reducing the number of layoffs that we will have to make."[xxii] At the time he projected a first year savings of $46 million and longer term savings due to a significantly reduced work force.
- In 2001, faced with a $1.4 billion deficit, Acting Governor Jane Swift proposed a 7% reduction in the state work force. Her budget chief said "she hopes most of the jobs can be eliminated through a new early retirement program."[xxiii]
- In 2003, in an attempt to balance the state budget while protecting basic state aid for K-12 education, Governor Mitt Romney proposed an early-retirement incentive program for state employees. At the same time, based on recommendations offered by Lieutenant Governor Kerry Healey, the Governor initiated a local mandate relief package that authorized cities and towns to offer another early retirement program for municipal workers.[xxiv]

In each of these instances, the governor, working with the state legislature and in some cases local officials, was able to utilize retirement incentives to address fiscal challenges. While we can debate whether the ultimate reduction in the public sector work forces offset the cost of these incentives, it's clear that these alternatives could not even have been considered in a defined contribution plan environment.

Section IV. Local Obligations – Local Accountability

Local officials – accountable to local taxpayers – should make bottom-line pension funding decisions.

The Massachusetts retirement system is actually comprised of 106 independent contributory retirement systems. Each of these systems is governed by Chapter 32 of the Massachusetts General Laws and is subject to regulation and oversight by the Massachusetts Public Employee Retirement Administration Commission (PERAC). Each system is administered by members of a board of trustees who serve as fiduciaries for the plan. With the exception of the State Board of Retirement and the Teachers Retirement Board, each of the boards is responsible for managing the assets of the system in accordance with the prudent-person standard.

The assets of the State Employees' Retirement System and the Massachusetts Teachers' Retirement System are invested in the PRIT Fund and managed by the PRIM Board. In addition, any local retirement plan can choose to invest all or a portion of the system's assets in the PRIT Fund.

Support for home-rule decision making shouldn't be interpreted as an endorsement of substandard investment performance.

Whether a plan's assets are managed by the PRIM Board or by a local retirement board, the liabilities of each system remain the responsibility of the governmental unit(s) that sponsors the plan. It's for exactly this reason that the decision-making responsibility for each plan should remain at the local level.

Two recent reform proposals have suggested that we abandon the fundamental principle of "home-rule" in order to save money. They suggest that it's fair to compare the investment performance of each retirement plan – regardless of its unique characteristics – with the performance of the PRIM Board. They argue that the investment objectives of the PRIM Board (which has $41 billion in assets) can be imposed on retirement systems as diverse at Boston ($3.2 billion) or Adams ($23 million) or Haverhill ($143 million) or the Greater Lawrence Sanitary District ($7 million).

By failing to recognize the unique characteristics of each plan they would have you believe that it's appropriate to adopt the same investment objectives for a plan that is 100% funded as you would for a plan that is 62% or 90% or 81% funded. They would suggest that it's appropriate to mandate a level of risk on the taxpayers of Pittsfield that has been determined by unknown PRIM Board members – regardless of the opinion of its elected leaders and pension fund trustees.

Support for home-rule decision making shouldn't be interpreted as an endorsement of substandard investment performance. Local officials and plan members should hold retirement system trustees accountable for doing the best job possible for the taxpayers and for the beneficiaries of the system. But, at the same time, state government should respect the decisions made at the local level – particularly when local officials and local taxpayers are ultimately responsible for paying the bill.

There's another aspect of this particular debate that warrants discussion. To compare fairly the performance of the PRIT Fund with other plans, one would have to assume that everyone has the opportunity to "play by the same rules." They don't. While the PRIM Board's investment discretion is totally unrestricted – except for a few statutory limitations – the investment authority of every other system is restricted by PERAC's investment regulations.

For example, the PRIT Fund's recent performance has been enhanced by its holdings in Alternative Investments. According to the PERAC 2005 Annual Report, "(i)n its below average allocation to domestic equities and above average exposure to non-traditional asset classes, PRIT's asset allocation is somewhat atypical of public funds nationwide."

Without offering an opinion as to whether the distinction between the PRIT Fund and local plans is right or wrong, it represents a material difference that must be considered when comparing bottom-line performance data.

In the end, the question shouldn't be 'How does the performance of any local plan compare against the PRIT Fund?' it should be 'How does each plan's performance measure up against the goals and objective that are appropriate for that unique plan?'

To illustrate the point, consider the following local plans.

- The Wellesley Retirement Board earned a 9.98% return for 2005 – 2.72% below the PRIT Fund. However, Wellesley's investment objective for 2005 was 7.7% – a goal that they exceeded by 2.28%. The Wellesley plan is 100% funded and in 2005 was able to fund a $7 million retirement "payroll" with no employer (taxpayer) contribution.
- In 2005, the investment performance of the Greater Lawrence Sanitary District Retirement Board trailed the PRIT Fund by nearly 9%. They missed their target by over 5%. However, their plan remains 99.3% funded.
- Most recently, the Haverhill Retirement Board …. (insert details)

It's pretty clear that the circumstances of each of these plans are quite different. Each board must consider different factors in developing its investment strategy and each board is likely to choose a different course. In the end, each board must determine the right answer for its broad circle of stakeholders.

Whatever they decide, stealing these plans from the control of locally elected and appointed fiduciaries by arbitrarily mandating a merger with PRIM is the wrong answer.

Section V. A Fair Assessment

In May, the Pioneer Institute for Public Policy Research published a White Paper entitled, "Public Pensions: Unfair to State Employees, Unfair to Taxpayers." The paper, written by a former staff member of the Commonwealth's Executive Office for Administration and Finance, evaluates the Massachusetts public retirement system, specifically as it relates to the State Employees' Retirement System, the Massachusetts Teachers' Retirement System, and the State-Boston Retirement System.

The report argues that the system is "fundamentally flawed" and "riddled with loopholes, ambiguities, and exceptions." It uses words like "manipulated" and "capricious" and paints a picture of a system totally out of control financially, a system that is transferring billions of dollars of debt to future taxpayers. It seeks to equate obscure and isolated plan deficiencies (that arguably should be amended) with early-retirement incentives and plan design amendments that resulted from sound public policy considerations and bipartisan executive and legislative actions.

The study, however, advances several contradictory arguments and leaves many questions unanswered. Consider the following excerpts:

- In its Executive Summary, the report states, "The weaknesses in the current pension system have already cost the state billions of dollars and reduced public confidence in the system. Until they are addressed, taxpayers will continue to pay." However, it later states, "The unfunded liability today stems <u>primarily from the fact that for many years the state operated on a pay-as-you-go basis and did not put aside money to cover future liabilities</u>." (emphasis added) Further, it states, "Because the contribution rates are higher for new employees, in some cases the state will actually pay out less in pensions than it receives in contributions and investment, <u>making a profit</u>." (emphasis added)
- The report suggests that the "Governor and Legislature should reform the pension system to make the cost of any changes transparent and <u>reduce the burden on taxpayers</u>." (emphasis added) At the same time, however, it states, "The expected cost to the state of eventually providing retirement benefits for all current employees is <u>less than 3 percent of payroll</u>. Barring any fundamental changes to the retirement system, as these older workers retire and are replaced with employees who contribute at a higher rate, <u>the state's share of pension costs will decline over the next 20 years</u>." (emphasis added)
- In more than one instance, the report criticizes the current system for calculating a benefit on factors unrelated to life expectancy. In describing weaknesses in the current formula – specifically as it relates to the age factor – the report states, "the calculations introduce inequities into the system because the steps are not necessarily connected to life expectancy." However, nowhere in the report is the relevance of a person's life expectancy to the value of a defined contribution plan – a savings plan based solely on contributions and investment income – noted.
- In the report's appendix, the author seeks to explain how much a pension costs the state: "The state assumes that it will earn an annual return of 8.25 percent on its pension fund investment. This implies that the state would have to invest $522,000 today to pay a $50,000 per year pension for 20 years – thus the actuarial liability associated with this retiree's pension is $520,000." While demonstrating a fundamentally flawed understanding of how defined benefit programs are funded, this statement ignores far more accurate analysis presented elsewhere in the report.

  For example, the report states that the Commonwealth "currently allocates funds each year to cover the expected future benefits for current employees (the 'normal' cost)". And, as previously noted, the report states that the employer cost for current employees is less than 3% of payroll and trending down. This rather modest employer (taxpayer) contribution is combined with the employees' contribution and invested over the employee's career to produce a fully funded pension benefit.

- The report's analysis of the 2001 and 2003 early retirement incentives indicates that the two programs "reduced annual payroll by approximately $400 million." While the report goes on to project the cost of the programs to the pension plan over 20 years, it makes no effort to project the impact of the $400 million savings from reduced payroll beyond the initial budget year. A similar omission is noted where the report indicates that the current pension fund appropriation of $1 billion represents 4% of payroll. The report projects the appropriation to double by 2023 to $2 billion but fails to calculate what percentage of state spending that might represent.

An honest reading of the White Paper should lead to some questions about the overall purpose and intent of the report. Based on the report's analysis, it's possible to conclude that current employee contribution rates may place an unbalanced burden on the workers. That might suggest that the current plan is unfair to employees. It's tougher though – if you follow the report's analysis of current plan costs – to conclude that the plan is unfair to taxpayers. In fact, reading the Pioneer Institute's White Paper in the context of all of the other information presented in this paper should cause a reasonable person to conclude that the Massachusetts pension system is a good deal for Massachusetts taxpayers.

The real unanswered question from the Pioneer Report is this: How is a defined contribution plan fairer to anyone?

Consider the following:

- Massachusetts taxpayers pay less than 3% to fund the pension plan of the Commonwealth's public workers – less than one-third the amount contributed by most private employers.
- The employees themselves contribute an amount that covers upwards of 75% of the cost of their pensions.
- Monthly benefit "payrolls" return millions of dollars to the Massachusetts economy, producing jobs and driving economic activity.
- Pension fund assets are a critical and reliable source of investment capital not only in Massachusetts but throughout the nation.
- By providing modest – but guaranteed – benefits, the pension plans help to ensure that the Commonwealth and its cities, towns and districts will have the skilled and committed workforce that is required to meet our everyday needs.

The real unanswered question from the Pioneer Report is this: How is a defined contribution plan fairer to anyone?

Epilogue

The purpose of this paper is not to argue that Chapter 32 is a perfect law or that every retirement plan is without faults – neither of these statements is true. However, these failings – whatever they may be – should not be used as a reason to destroy a retirement plan that's clearly keeping its promises to Massachusetts taxpayers and public workers.

In many ways, Chapter 32 is somewhat analogous to a historic old home – weathered by the passing of time, modified by the changing needs of its owners, showing some signs of wear and tear that require routine maintenance – but also rich in history, firmly anchored on its foundation, full of character and definitely worth preserving.

It's from this perspective that any reform initiative should begin. The Legislature should consider the following:

- Two creditable organizations, PERAC and the Public Service Committee's Blue Ribbon Panel, have submitted thoughtful proposals that deserve consideration. Both sets of recommendations acknowledge the underlying strength and importance of the existing system and both seek to address specific weaknesses as perceived by their authors. Whether they are ultimately enacted into law or not, they represent an opportunity for constructive debate to improve the overall retirement system.
- No one supports protecting the independence of a chronically underperforming local retirement system. A process should be developed that would hold each system accountable to a series of objective and measurable criteria. A system that fails to meet these criteria over a fair period of time should be deemed "at risk" and appropriate remediation should be mandatory.
- While the cost of the Massachusetts pension system to employers (taxpayers) is a critical discussion, this paper and others have documented that the "shared responsibility" envisioned in a Defined Benefit program has broken down. Massachusetts public employees are paying a disproportionate share for their benefits – a fact that must be at least considered in any future reform of the system.
- Finally, although a defined benefit plan is largely designed to reward career employees, it must also be fair to shorter-term workers. Future reforms should investigate options for providing a more equitable return on investment for short-term public workers.

Thoughtful consideration of these and other constructive ideas will preserve the pension system as a good investment for Massachusetts.

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