Nevada Pension Reform: First, Do No Harm

Oral testimony to the Nevada State Legislature

Teresa Ghilarducci | March 3, 2015

The Nevada pension plans for state and local workers are among the best-governed and well-designed plans in the nation. Employers and employees share equally in contributing to the plan, the employers steadily fund the annual required contribution, and the funded status for Nevada's public employee DB plans are improving faster than the national average. All defined benefit pension plans suffered from the Great Recession, but Nevada's public pension plan is now over 71% funded, a level deemed adequate. In addition, the fund is moving towards full funding status given the commitment of the state to fund the ARC.

Nevada's pensions are not overly generous, the accrual rates are near national averages. Nevada public sector retirees earn wages similar to what is earned in the private sector, in some cases less, but public employees are much less likely than private sector employees to be poor or near poor retirees.

In my opinion, Nevada is a healthy DB system. Nevada has, what we call in the trade, good pension "hygiene." Unlike New Jersey, Rhode Island, or Pennsylvania, for example, Nevada has not significantly underfunded its plan over the years. Public employees in Nevada contribute an unusually high share—half. Most public plans require employers to contribute the majority of total contributions.

The Nevada system has always been funded on an actuarial basis and followed recommended actuarial practices. The system has used accounting methods designed to smooth pension contributions over time, unlike some states that switched to market valuations and actuarial techniques that reduce contributions when the fund is doing well – precisely the time a well-run fund should be accumulating surpluses.

Recent Experiments with Different Benefit Designs Results in Returning to the Defined Benefit Model

States have developed pensions for their public sector employees for over a hundred years and have continually experimented with different benefit designs. Some state plans are much older than Social Security. Therefore, there has been a lot of experimentation, including experimentation with hybrid plans. Some hybrids have been in place in public sector retirement systems for decades. Hybrids consist of career average plans; but, mostly hybrids refer to a DB system with a mandatory DC plan stacked on top of one. For years, I was a trustee of the Indiana PERF when I lived in Indiana while teaching at the University of Norte Dame. Indiana had a stacked, hybrid design, along with a handful of other states, since the Great Depression.

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In sum, many states have considered closing their traditional pension plan to future (and, in some cases, existing) employees and found that the switch in plan design could increase—rather than reduce— plan liabilities and costs. States and municipalities considering switching to 401(k)-type plans have been deemed by analysts to be risky and expensive. DC plans do not meet important budget and retirement security objectives. 401(k) type plans do not meet the objectives of:

- Providing long term workers with a stream of income until they die;
- 401(k) – type plans do not meet important human resource objectives to attract and retain the most valuable, loyal, employees; and
- 401(k) plans are often more expensive because they drain contributions to the current DB plan and the fees and inefficient investment management causes a dollar of benefit to be more expensive than it otherwise would be obtained in a DB plan.

Therefore, most states have chosen to retain their defined benefit (DB) plan by implementing good pension hygiene: increase employer and employee contributions to fully fund the plan, restructuring benefits to cut benefits or knock out special features like spiking, and have moved to fully fund increases. Almost always, when considered, a wholesale design change was considered too disruptive and too costly without providing any corresponding and meaningful benefits. For some plan administrators and political leaders, using good pension hygiene rules has been difficult. More states should follow Nevada's pension fund and management model to amortize liabilities over 20 years; adopt the EAN actuarial method; do regular actuarial studies; fully fund improvements; and take Nevada's measured approach to risky real estate and hedge fund and private equity investments.

A cash balance plan is a hybrid that combines elements of traditional pensions with individual accounts into a single plan. It is also called a career average plan.

Attempts to freeze current DB plans has been considered and rejected in many states because of two major bodies of evidence pertaining to the double payment problem and the high future cost of low pension benefits.

1. Double payment problem: Freezing a DB plan causes costs to increase, not decrease.

2. Inadequate pension benefits to public sector retirees can cause significant costs to an employer in two ways: public employers have a weakened ability to attract and retain a desired, high quality workforce and two, public employers find that as more retired public employees rely on hybrid pensions often have to collect welfare and other means-tested programs. The short term savings on pensions raises long terms costs for municipalities and states.

Some states have experimented with freezing and substituting their defined benefit (DB) plans with 401(k) plans or hybrids. Three states have frozen their DB plans to new employees and put all new hire in 401(k)-type plans: West Virginia in 1991; Michigan for its state employees in

1997; and Alaska in 2006. In all three of these states the changes have increased the state's pension debt beyond what it would have been if their DBs plan had been kept intact.

West Virginia, in 2006, reopened its DB plan to all new hires and allowed the members of the 401(k)-type plan, which they had participated into since 1991, back in the old DB plan. While WV pensions fell so did the funding status of the frozen DB plan. Before the workers came back into the West Virginia DB plan, the funding ratio fell to a national low of 18 percent in 2003. And, workers got a bad pension deal. Individuals in the 401(k) accounts only earned 3.39 percent from 2001 to 2006; whereas, the old DB plan earned 6.13 percent. The 401(k) accounts were meager, most people had averages equally about $23,200, causing, what local administrators called a "red truck" syndrome. Instead of annuitizing their lump sum -- for would turn out to be a tiny monthly benefits-- retirees bought consumer durables, "red trucks," and other durable goods. There were palpable increases in the use of means-tested public programs of retirees who otherwise would have had a DB annuity and most likely would not have had incomes near and below the poverty level.

The consequence of freezing DB plans is also seen in Michigan. Michigan started enrolling all new state employees in a 401(k)-type plan in 1997. Since new employees were not contributing to the old plan, and had to contribute to the new plan, the system still had to pay benefits to the old members while assets were falling. The system's unfunded liabilities increased from $697 million in 1997 to $4.1 billion 13 years later. Alaska's story is similar. Their 401(k)-type plan for new state and public school employees began in 2006. Because of the double payment problem, illustrated in West Virginia and Michigan the state had to put in more money into the system than they otherwise would if they hadn't siphoned off contributions into a DC plan. Alaska required contribution rates nearly doubled.

For Alaska state employees, the actuarially determined employer contribution rate required to pay of the unfunded liabilities increased from 12.4 percent of salary in 2006 to 22.5 percent in 2012. For teachers it was worse, the rate increased from 24.6 percent to 36 percent.

I was a trustee of the Indiana PERF from 2001 – 2007 and we accepted the Bureau of Motor Vehicles employees back into the DB plan, mainly because funding the same dollar of benefit was much more expensive in a 401(k) plan. They too had conducted a too-expensive experiment with a DC plan.

More Expensive

There are two reasons why hybrid systems are more expensive despite providing a less valuable benefit. First, DB pensions are more cost-effective than DC plans because of lower rates of return in DC plans and higher annuitization costs. Hybrid plans may be less cost-effective because they provide a less valuable benefit to most workers, especially career employees who are often the most productive and can move elsewhere.

Conclusion

The claims that career average plans are better are narrowly focused on the drastic cut in benefits the new formulas cause. DB pensions are more cost-effective than DC plans. DB pensions are also highly valued by workers, who accept lower pay in exchange for secure benefits.

Therefore, any savings from cutting DB pensions will prove illusory, as employers are forced to offer larger pay increases or more expensive DC benefits to attract and retain a quality workforce. Though states can save money in the short run by reneging on pension promises, taxpayers will face higher costs in the long run if workers no longer believe these promises will be met.

I recommend that the legislature build on the well-run Nevada system and communicate its excellent governance and funding practices to the public employer community. (I plan on doing so in my writings and speaking activities). But, first, do no harm by changing the governance, the investment mix, the pension design, and the contribution flows.

To gild your already golden practices Nevada may want to consider the costs and benefits of including workers into Social Security and develop ways to provide affordable and best in class retiree health benefits.

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