NASRA

Analysis of Latest ALEC paper
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The American Legislative Exchange Council (ALEC) this week published an update to "Unaccountable and Unaffordable," a study of public pensions. The report, accessible here, is based on an examination of more than 290 state-administered public pension plans.

As with prior years' editions, the methodology and findings of the ALEC study contain serious flaws. For example, the report:

- Bases its conclusions on the use of an unreasonably low, risk-free interest rate to calculate the liabilities and funding condition of public pension plans;
- Ignores investment returns of public pension funds that exceed benchmarks while comparing public pension investment return assumptions with irrelevant interest rates and metrics;
- Acknowledges the benefit of only pension reforms that move retirement benefits toward hybrid or defined contribution plans, ignoring manifold efforts among states in recent years to advance and ensure the sustainability of their pension plans.
- In calling for pension plans to be replaced by defined contribution plans, is oddly detached from labor market reality: public employers face acute and ongoing challenges to attract and retain qualified workers, and a pension benefit is a key element of public employment compensation.

Conclusions are based on an unreasonably low investment return assumption
The report's primary finding is that public pension plans are badly underfunded, far worse than plans report using standard, recognized methods for valuing liabilities. Specifically, ALEC contends that the aggregate unfunded liability of plans in its study is $8.28 trillion, with aggregate state funding levels ranging from 18 to 56 percent. Compared to ALEC's previous report, published one year ago, this combined unfunded liability is higher by more than $2 trillion. By contrast, using current, prevailing actuarial methods for valuing liabilities, public pensions report an aggregate unfunded liability of approximately $1.5 trillion and a funding ratio of around 73 percent.

ALEC's funding calculation applies a discount rate derived from the yield on a hypothetical 15-year U.S. Treasury bond, calculated by averaging the yields as of mid-2020 on 10- and 20-year US Treasury bonds. This results in a so-called risk-free discount rate of 1.13 percent. This extraordinarily low rate reflected the sharp decline in interest rates that occurred shortly after the onset of the pandemic. The rates used for corporate pension plans for the same timeframe were around 3.5 percent.

Using a current, spot interest rate to calculate a pension plan's long-term funding requirements and to characterize the funding condition of a pension plan that will continue to operate for decades, is inconsistent with the way plans are funded. Public pension plans typically calculate their liabilities using their expected long-term investment return, a methodology supported by the Governmental Accounting Standards Board (GASB) and the Actuarial Standards Board (ASB).

Public pension funds invest in diversified portfolios that are projected to generate investment earnings over long investment horizons. On average, their assumed rate currently is 7.0 percent, and is more conservative than actual median investment returns for the 10-, 20-, and 30-year periods ended in fiscal year 2021. The primary purpose for valuing liabilities this way is to determine the plan's funding requirements, i.e., how much the plan needs this year and each year in the future, to fund promised benefits. As has been discussed and documented repeatedly in recent years, this method for calculating liabilities is intended to promote predictability and stability in the cost of the plan, and to minimize plan costs within an acceptable level of investment risk. Use of a risk-free rate is inappropriate for calculating pension funding requirements because doing so: a) would result in volatility in required contribution rates; b) significantly overstates the required cost of the plan; and c) understates the plan's funding condition.

The ALEC report recognizes the benefits only of pension reforms that move retirement benefits toward hybrid or defined contribution plans

The report's rating of pension reforms recognizes only three types of reform: those that contain an "automatic trigger" to adjust contribution rates or benefit levels; plans that automatically enroll workers in a hybrid plan; and those that close the defined benefit plan and automatically enroll newly hired employees in a defined contribution plan.

In fact, the report's scoring matrix rewards plans featuring automatic enrollment in a DC plan with two to four times the number of "points" that the other recognized reforms receive. Other types of reforms, such as those that increase required employee contribution rates, reduced benefits, or lengthened eligibility requirements, are not recognized in the report. Fully one-half of states receive zero points for pension reform in ALEC's scoring matrix, even though nearly every state has enacted substantive pension reform in the past decade. The only states that receive full points in this area are Alaska, Michigan, and Oklahoma, where new state hires have access only to a DC plan.

ALEC's report extols the virtues of switching public employees to a defined contribution plan, stating:

> Transitioning new hires to a defined contribution pension system is the best reform a public retirement system can make because it addresses the key problems with pension underfunding.

The report makes this assertion while ignoring that closing a pension plan and establishing a DC plan only for new hires, (which ALEC itself acknowledges would be the only legal option in many states, as legal protections preclude switching current pension plan participants to a DC plan) does nothing to address the existing unfunded liability of the pension plan. In fact, closing a defined benefit plan and switching to a defined contribution plan can increase the taxpayer cost of financing the unfunded liability of the closed pension plan due to reduced employee contributions and a shrinking covered payroll base.

The ALEC report is oddly detached from labor market reality: public employers face ongoing challenges to attract and retain qualified workers, and a pension benefit is a key element of public employment compensation

The primary purpose for sponsoring a retirement benefit is to attract and retain qualified employees who are needed to perform essential public services. Particularly since the pandemic, all employers have struggled to hold on to current employees and to fill open positions. Current levels of wage growth for state and local workers are considerably lower than inflation and private sector wage growth, a likely contributing factor to the lag in aggregate public sector employment. Traditionally, a distinguishing feature of public employment has been a retirement benefit that compares favorably with what is available outside of public employment. This retirement benefit normally is intended to make up for salary and wages that are less competitive with employment opportunities outside of the public sector.

Focusing solely on the direct cost of retirement benefits, the ALEC report is silent on this key purpose for providing a retirement benefit in the first place. Experience suggests that switching to a DC plan has been associated with other unintended consequences in states that have implemented this change, including higher levels of retirement insecurity and difficulties recruiting and retaining qualified public employees. Closing pension plans for public employees in lieu of a defined contribution plan would have significant and negative consequences for the nation's thousands of public employers: school districts, police and fire departments, state agencies, sheriff's offices, etc. Removing a vital pillar of compensation for public employees, without adjusting other elements of compensation, would exacerbate the already strained ability public employers are experiencing in attracting and retaining employees.

Public Policy Should be Based on Factual, Relevant Information

Proper financing of the nation's public retirement systems is an important policy issue that requires factual data and analysis and an understanding of the public budgeting process. NASRA's Standing Resolution on *Guiding Principles for Public Retirement System Plan Design and Sustainability* expresses the organization's support for "policy-driven decision making that recognizes the retirement security and workforce management purposes of public employee retirement systems, and which is based on objective and pertinent information that fairly reflects the long-term time horizon and economic effects of public plan financing, benefit adequacy and benefit distributions."

Similarly, NASRA's Resolution on *Funding Discipline in Public Employee Retirement Systems* states that "predictability and stability of required costs are the foundation of public sector budgeting and enable policymakers, and ultimately taxpayers, to assess the underlying true cost of any long-term public program, and the imposition of elements that would cause wide swings in required pension costs would be unnecessarily financially disruptive, confusing and counterproductive." ALEC's use of current interest rates, which are prone to volatility, to measure long-term public pension liabilities, is inconsistent with public pension funds' historic and projected long-term investment returns and conflicts with NASRA standards for public pension policy, plan design, and funding practices.

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