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Public Pensions Work- And These Three Systems Prove It

By Tyler Bond

Defined benefit pensions remain the most secure and reliable retirement plan for working families. The evidence continues to mount that defined contribution plans, like 401(k)s, do not provide an adequate retirement for anyone other than wealthy corporate executives.[1] Pensions keep working families out of poverty during retirement because they provide a steady, monthly income that is guaranteed for life. For public employees in particular, defined benefit pensions are a valued job benefit and that is why states and cities are sticking with public pensions.

While some corporate special interests have been spreading mistruths about the state of America's public pension funds, the reality is that most public pension systems are reasonably well-funded and provide an adequate retirement benefit to teachers, firefighters, nurses, and other public employees after their careers serving the public.

This report will examine three of the most successful public pension systems in the country. These three pension plans offer a roadmap to success for other pension systems looking to provide a secure retirement for their public employees. While each is unique, their common commitment to sound funding practices and responsible management ensures that the retirees of these systems can enjoy the dignified retirement they deserve.

I. District of Columbia Retirement Board

Public pension funds do not just spring into existence fully formed. They grow and develop over time, just like the people they serve. The pension funds managed by the District of Columbia Retirement Board (DCRB) are relatively "young" funds and provide a good example of how pension systems change as they mature and add more members.

Due to the unique political situation of the District of Columbia, the pensions of DC police officers and firefighters were originally paid for by the federal government. The pension benefits for these public servants were paid directly from the U.S. Treasury on a "pay-as-you-go" basis and the benefits were not pre-funded according to actuarial methods.[2] Following passage of the Retirement Reform Act in 1979, the DCRB was created and the federal government began pre-funding the pension benefits of DC police officers and firefighters.[3]

When the DCRB was created, the federal government transferred all of the pension liability to the DC government; however, it did not also contribute the funds needed to pay for benefits that had already accrued.[4] This caused the District of Columbia's unfunded pension liability to balloon. It wasn't until 1997 and passage of the Revitalization Act,[5] followed in 1998 by the

Replacement Plan Act,[6] that the District of Columbia assumed responsibility for paying the pension benefits of the city's police officers and firefighters. The federal government assumed all responsibility for pension benefits earned before June 30, 1997. The DC government began covering all pension benefits beginning on or after July 1, 1997. This means the pension funds managed by DCRB are less than two decades old.

Early in the "life" of a pension fund, contributions of employers and employees make up a greater percentage of the revenues of the fund. As the fund matures, the earnings on investments managed by the fund will begin to represent a greater portion of plan revenues. In part, this is because as pension systems grow and the number of members in the plan increase, there will also be an increase in the number of retired members who begin claiming benefits. This reduces the ratio of active workers to retired workers. Additionally, though, it takes a while for the plan's investments to start earning consistent returns. As these investments develop, their returns will account for a greater portion of plan revenues.

The District of Columbia Police Officers and Firefighters' Retirement Plan is a well-funded pension system with a current funding ratio of 107.3 percent.[7] The DC government pays its full annual required contribution to the pension fund each year. If the DC government maintains its commitment to its pension fund, then its public safety officers can expect to continue enjoying a secure and reliable retirement.

II. Illinois Municipal Retirement Fund

One example of a strong statewide public pension system is the Illinois Municipal Retirement Fund (IMRF). Many of Illinois' public pensions are notoriously underfunded, the result of decades of neglect by the state's political leaders. However, the IMRF is an exception and for one good reason: municipalities are required by law to make their annual contributions.

This year IMRF celebrates its 75th anniversary of providing retirement security to municipal employees throughout the Land of Lincoln. Though created by the state, the IMRF is independent of the other statewide public pension systems in Illinois and is not funded by the state legislature. Rather, the IMRF receives annual contributions from the counties, cities, and towns that participate in it. The first five municipalities to join IMRF were: the city of Evanston; the village of Riverside; the city of Galesburg; the city of Rockford; and the Rockford Park District.[8] Now, IMRF serves 2,976 employers across the state.[9]

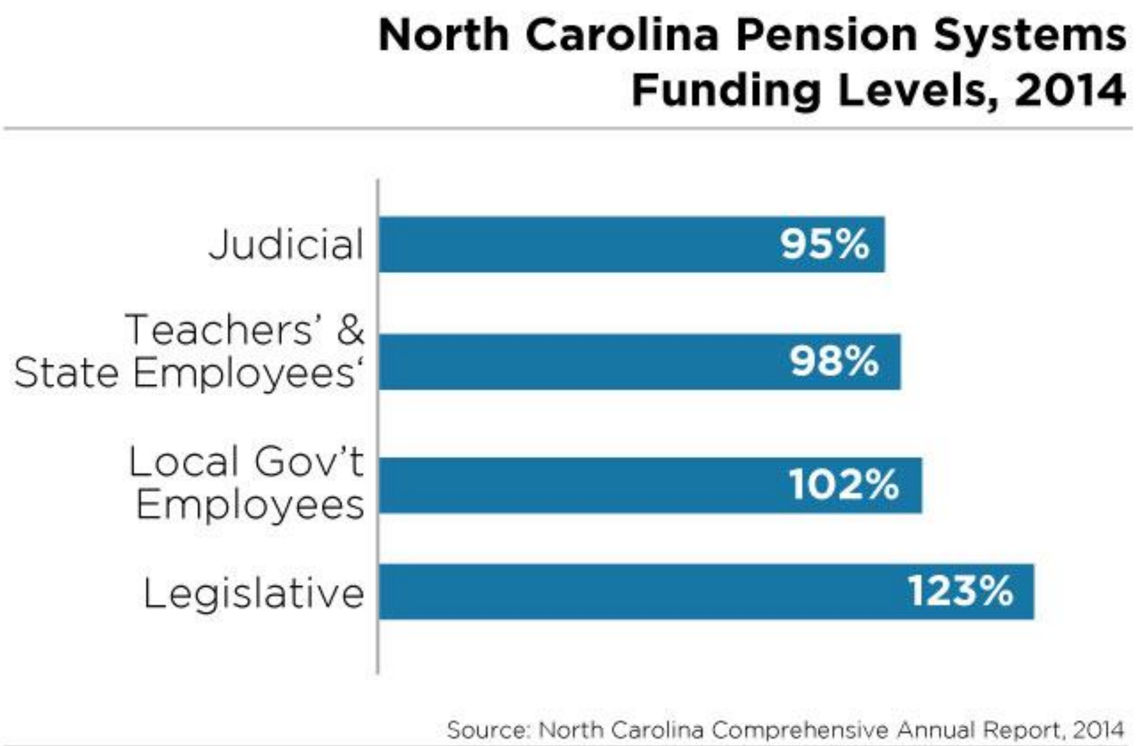
A recent economic analysis of IMRF found that it generates over $2 billion in economic activity in Illinois each year.[10] In part, this is because 85 percent of IMRF retirees live in Illinois. In 2015, IMRF paid out $1.49 billion in benefits to 112,762 benefit recipients.[11] The average annual benefit was $21,492 in 2015- a modest amount, but enough to guarantee a secure retirement.

III. North Carolina pension systems

The state of North Carolina has a robust public pension system for its teachers, firefighters, police officers, and other state employees. The North Carolina treasurer oversees four statewide defined benefit pension systems:

- The Local Governmental Employees' Retirement System
- The Teachers' and State Employees' Retirement System
- The Consolidated Judicial Retirement System
- The Legislative Retirement System

The treasurer's office also manages several other funds and defined contribution plans. In this report, however, we are going to focus on the first two of the pension systems: the Local plan and the State plan.



One reason North Carolina's pensions are so noteworthy is not only that they are comprehensive- they cover 1 in 8 working North Carolinians[12] - but they are also all well-funded. In fact, the state is known for its commitment to funding its pensions. This point cannot be emphasized enough: adequately funding pensions each and every year is the single most important thing a state can do to properly manage its pensions and ensure a secure retirement for its public servants. No investments in alternative assets or cuts in benefits can make up for poor funding practices, especially if that inadequate funding occurs over a long period of time. North Carolina teaches us this lesson better than any other state.

The Local plan in North Carolina is similar in many ways to the Illinois Municipal Retirement Fund. It covers employees of counties, cities, and towns throughout the state. It includes police officers and firefighters as well as non-safety personnel. One of the benefits of plans like this is economies of scale and efficiency. Having all of the cities, towns, and counties in a state join together in one large system is more economically efficient than having each of those municipalities manage and administer their own plan.

> *North Carolina Improved Pensions During the Recession*
> The state government has historically made its annual required contributions each year and this allowed North Carolina to avoid making benefit cuts for pensioners during the recession. In fact, North Carolina had passed a law increasing the vesting period for pensions from five years to ten years, but changed it back to five years when they realized it didn't actually save them much money and it harmed the retirement security of their public employees.[13] This happened during the recovery from the financial crisis.

North Carolina also uses a 12 year amortization period to pay off its unfunded liability for its pensions.[14] An amortization period is the amount of time granted to pay off debt. Twelve years is an unusually short period. Many states use 25-30 year amortization periods. Using this shorter period requires a commitment from the state government to paying off the debt quickly and making the annual required contributions, but it also keeps the unfunded liability low and the pensions well-funded.

North Carolina's pensions are some of the strongest in the country, but that hasn't stopped anti-pension ideologues from attacking them. In recent years, these ideologues have proposed moving North Carolina's public employees into a risky and inadequate defined contribution system, not because North Carolina's pension plans are underfunded, but simply because they are ideologically opposed to defined benefit pensions. As has happened in other states like West Virginia and Michigan,[15] converting from a defined benefit pension plan to a defined contribution plan creates enormous transition costs. It also dramatically increases the unfunded liability of the pension system and severely weakens the retirement security of public employees. Without new employees paying into the system, the fund will have to start investing much more conservatively over time just to maintain its current risk profile. North Carolina should not squander the well-managed and well-funded pension system it has spent decades creating for its public employees.

IV. Lessons Learned

The most important lesson from these successful pension systems is the importance of making the full required pension payment each year. Last year the National Association of State Retirement Administrators published a report on states and their commitment to making their Annual Required Contributions (ARC) to their pension systems. The report found that most states paid most of their ARC each year.[16] The few states that didn't are extreme outliers and drag down the averages for all states. A similar report released this year finds that states paid, on average, 91 percent of their required annual contribution in FY 2015.[17] What this tells us is that most states are committed to funding their pensions each year and, as we have seen, proper funding is key to the success of a public pension plan.

The states where pensions are severely underfunded are well-known. In each of these states, there are unique historical reasons for the underfunding. Most often, the reason has been neglect by the state's elected officials of proper funding levels. There is nothing inherent in the design of defined benefit pensions that causes underfunding. Public employees contribute a portion of each paycheck toward their pension. So long as the government, as an employer, also makes its full contribution each year, then the pension will be sustainable over the long-term. Certainly there will be periods when investment returns will be low, but there will also be periods when investment returns will outperform their targets. What has harmed states like New Jersey and Kentucky is that elected officials neglected making anywhere close to the full ARC payment for years on end. In the case of a state like Connecticut, the state did not pre-fund its pensions for decades and the current system is still carrying that enormous legacy cost.

How states ensure funding discipline varies, but the IMRF model is a good one: payments are required by law so that irresponsible politicians cannot shirk their responsibilities. The financial crisis in 2008 hurt all public pension systems, but the ones that received adequate funding from the state are recovering well from the worst of the recession. The pension systems that were already in bad shape before the recession are in worse shape after it.

Another important lesson has to do with economic efficiency and economies of scale. Pension systems like IMRF and the North Carolina Local Plan are successful in part because they utilize one system for the entire state. All of the counties, cities, and towns pay into one system, with one management structure, one investment team, etc. In these states, one small town with only a few hundred public employees does not have to manage an entire pension system all on its own.

Additionally, North Carolina has used a conservative investment strategy and a short amortization period to avoid making benefit cuts, even during the midst of a severe recession. It takes political will to utilize a short amortization period and keep unfunded liabilities low, but that has certainly contributed to the success of the North Carolina systems. Investment strategy is a tricky subject, but states should examine whether high-cost investments like hedge funds are delivering worthwhile results.

For over a hundred years now, cities and states have used defined benefit pensions to provide a secure and reliable retirement for their public employees. While there are some states with severely underfunded public pension systems, these states are the exceptions. Most states properly fund their pensions each year and, therefore, have reasonably well-funded public pensions. A few public pension systems are particularly strong because of unique design features and a history of commitment to the pension fund on behalf of the state government. These systems offer lessons for other states as they seek to strengthen their pensions and guarantee a secure retirement for their public employees.

Endnotes

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