Testimony to the Montana Legislative Finance Committee

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Good morning. I want to thank the committee for inviting me here today and for their interest in what is one of the most important policy issues facing states right now. My name is David Draine and I am the lead researcher on public sector retirement systems at the Pew Center on the States. We've been studying public pensions and retiree health benefits to help policy makers make sound, data-driven policy choices and to strike the right balance between controlling retirement costs and being able to recruit and retain a talented public sector workforce. We've partnered in this effort with the Laura and John Arnold Foundation. Of all the bills coming due for states, perhaps the most daunting is the one for pensions, retiree health care, and other retirement benefits.

We looked at Montana's financial reports and the actuarial valuations from the state's pension plans. And what we found was troubling. Montana is on an unsustainable course with its unfunded pension promises that will continue to impact the state's fiscal health if action isn't taken. Even though in 2000, the state's pension plans had a $244 million surplus, by 2011 they faced a $3.9 billion shortfall between what should have been set aside to pay for pension promises and what has been set aside. All these figures come from the state's own numbers. Both the Montana Public Employees' Retirement System and the Montana Teachers' Retirement System project that under current policies, this unfunded liability will never be paid off. Let me repeat that. If Montana does not change how it manages its retirement systems, the pension debt that is owed to current workers and retirees will never be paid for under the plan's assumptions.

How did Montana get here? After all, the state's plans were fully funded in 2000, with a surplus. But the combination of increases in benefits that weren't paid for when offered and investment losses from the 2001 recession created a funding gap that continued to grow, reaching $1.3 billion in 2007, right before the Great Recession. The State's pension debt now totals $3.9 billion, more than $9,700 per household in the state.

Part of the challenge is that Montana has not been putting aside enough to fund the promises being made. The actuarial required contribution, also known as the ARC, is the standard benchmark of whether public employers are making adequate payments into a pension plan. This is the combined cost of paying for new benefits as workers earn them and paying off the state's existing unfunded liabilities over a reasonable time frame. When investment losses are substantial, a state needs to be even more diligent about making adequate annual pension payments. For example, when the 2001 recession resulted in a growing funding shortfall for Montana, public employers needed to set aside more money each year to pay off that pension debt. But instead, as the actuarial required contribution or ARC went up, the state fell short in making the full payment each year. For the Public Employee's Retirement System, the state made just 55 percent of the recommended contribution in 2011. The state and school districts had a better record with funding the Teachers' Retirement System-particularly when the state put $150 million in one-time contributions into the plan in 2006 and 2007. Still, the plan's actuaries are finding that the Teachers' Retirement System's contribution rates going forward will no longer be sufficient to fully fund that plan.

All told, the ARC for Montana pensions doubled from 2005 to 2011 but actual contributions only grew by 50 percent over that period. The reason is that Montana doesn't set its contribution policies to make sure that actuarially appropriate contributions are set aside to pay for pension benefits. Offering a traditional pension plan in a sustainable way requires a discipline towards funding that has recently been absent in the state.

Ultimately this is a problem because Montana is incurring a growing pension debt without a plan to pay for it. Make no mistake, the unfunded liabilities facing taxpayers in Montana are an obligation of the state. While there may be ways to ask employees to be part of the shared sacrifice, for the most part closing these funding gaps will require policy makers to make some tough choices and either raise revenue or find ways to reduce spending in other places. Part of the reason the pension crisis is such an important policy area is the potential for pension costs to crowd out other important public investments in education, roads, and public safety. Unmanageable pension costs also hurts the state's ability to reward current employees because tax dollars end up diverted to pay for past services—containing pension costs are among the challenges facing Montana while public employee salaries remain frozen. All told, 20 cents of every dollar that the state put into the Public Employees Retirement System in 2011 were to pay for past promises rather than to pay for new benefits earned by current workers.

Furthermore, the state should have set aside twice as much in order to close the funding gap over 30 years.

The more that Montana delays in solving this problem, the bigger the problem gets and the more painful the available options. Ultimately, the bill will get paid but it matters a lot to a state whether it happens gradually or all at once. Looking at the Montana PERS plan, the cost of doing noting becomes readily apparent. Based on current policy, that plan's contributions in 2046 are projected to be $574 million. But by the next year, the plan will have run out of money and employers will need to switch to a pay as you go basis, requiring a sudden increase in annual payments that would more than double to $1.3 billion. Similarly, contributions to TRS in 2040 are projected to be $286 million under current policy. But, when TRS runs out of money in 2041, those contributions would swiftly grow to more than $600 million.

Montana is not alone. All told, the 50 states faced a $1.38 trillion funding gap for their pension and retiree health care plans. The unfunded liability for state pension plans alone was $757 billion. And many cities and towns that run their own pension plans are finding costs rising and funding gaps growing even as the money to pay for it becomes hard to find.

Of course, there is substantial variation and there are states that have managed their retirement liabilities effectively. North Carolina, New York, and Wisconsin have kept their traditional defined benefit pensions well-funded while states like Georgia and Nebraska use alternative defined benefit plan designs that offer their workers retirement security while keeping costs and risks manageable.

States with substantial unfunded liabilities often have some similarities—policy makers failed to make the full actuarially recommended contributions while offering unfunded benefit increases even as investment returns fell short and other actuarial assumptions proved incorrect. Bad policy is part of the story but the other piece is that traditional pensions present some structural problems built into their design.

First, costs under these plans are neither predictable nor transparent. Because the bill comes due long in the future after pension promises are first made, it is hard to calculate exactly how much employers should set aside. This can force state and local governments to deal with costs that spike and dip. And because there is this disconnect between benefits being offered and the ultimate bill, policy makers have to resist the temptation to underfund these pension plans. We can see the impact of rising pension funding gaps on contributions—while the contribution rate necessary to fund Montana's pensions in 2000 was just 6.3 percent of payroll, that had gone up to 9.2 percent of pay in 2005 and more than 19 percent of salary in 2010.

Second, public employers offering a traditional defined benefit are taking on a number of risks, perhaps most importantly, investment risk and longevity risk. If investment returns end up below expectations while retiree life spans go up, taxpayers can find themselves on the hook for substantial costs. How much risk to take on is a policy choice and some states may choose to insulate workers from all risk while others might be uncomfortable passing any risks to tax payers.

The important thing is for policy makers not to take on more risk than their state or city is able to cope with. The implications of the recessions of 2001 and 2007 suggest that many states ended up with more risk than they could handle as costs were higher than they had budgeted for. Some estimates for the Montana PERS plan show the impact of investment returns on future costs—if pension returns were only 6.25 percent instead of the assumed 7.75 percent, then the contributions needed to pay for PERS would rise to be approximately 25 percent of employer pay. Furthermore, even if investments were instead 9.25 over the long term, there would remain substantial unfunded liabilities that taxpayers would remain on the hook for.

Third, the traditional defined benefit backloads benefits, meaning that employees earn most of their pension benefits late in their career. This can create an incentive for mid-career workers to work longer, which, in some instances, may help the state retain experienced workers. However, it also means that an employee's retirement security is dependent on them working for the same public entity until a certain age. Traditional pension plans can also provide an incentive for experienced workers to leave once they reach their specified retirement age, even if they want to continue working and the state continues to want to employ them.

Note that in Montana's case, the PERS plan does not have the same kind of backloading common among other plans as workers get either the traditional pension benefit or what is called the money purchase benefit, whichever is higher. The money purchase benefit, which is similar to a cash balance benefit, offers an annuity based on employee contributions and interest credits, which is more beneficial to workers early in their careers. As a result, the PERS plan is much more generous to workers early in their careers than TRS; a worker who joined PERS at 25 and left at 42 would get twice as valuable a benefit as a similar teacher in TRS. The comparison switches for career employees, where TRS offers a more generous benefit than PERS.

Ultimately there is no one-size-fits-all solution and policy makers in Montana will need to pick a plan that works for their state. Pew and the Laura and John Arnold Foundation are looking to provide free support to policy makers to make sure that they have the data and analysis they need to make sound, data-driven policy choices and to ensure that policy makers understand the different options and the tradeoffs behind each approach.

While there are many different ways to fix Montana's pensions, ultimately any successful, comprehensive reform effort will do several things.

Any reform in Montana needs to include a credible plan to close the state's funding gap over a reasonable time frame. This means putting more money into the system by making the full recommended contributions. Ultimately these promises will need to be paid but it is important that states make these payments sustainably and over time rather than having the fiscal impact hit all at once. Of course making these contributions will take money away from other important public priorities and it may be necessary to ask Montana workers to be part of the shared sacrifice needed to close the funding gap. Some of the proposals we've seen in the state so far have included asking public employees to contribute more toward their pensions.

Closing the funding gap is important but policy makers will need to fix the system that allowed the funding gap to emerge in the first place. Montana will need to make sure that the benefit being offered to new hires is affordable, sustainable, and secure. This means making sure that costs are both predictable and transparent and that contributions are consistently made. It also means making sure that the state is not taking on more risk than it can manage, while ensuring that the benefit puts all workers on a secure retirement path.

Finally, Montana offers a pension benefit for a reason—to recruit and retain the talented public sector workforce that state residents depend on. This means that closing the funding gap can't only be achieved by changing pension rules for new employees, there is not enough money there and it would require draconian cuts.

It also means that policy makers in the state will need to think about total compensation, not just pensions, because if paying rapidly rising pension costs results in stagnant wages or layoffs then the state might still fall short of its recruitment and retention goals. Controlling retirement costs is important but pension reform also needs to ensure that total compensation helps Montana recruit and retain the modern workforce that it needs to achieve its policy goals.

We've already seen interest in Montana to tackle this issue and we commend these efforts. This is an important policy issue and the sooner comprehensive reform is achieved, the less drastic the solution will need to be. Governor Schweitzer's proposal has been getting attention so I would like to take some time addressing those recommendations. For both Montana Public Employee's Retirement System and the Teachers' Retirement System, the proposed legislation would increase employee and employer contributions. There would also be additional funds used to shore up the pension plans—coal taxes for PERS and an additional state contribution for TRS.

This proposal would get Montana on track to eventually pay off its unfunded liabilities, albeit in 40 to 50 years. We think that this bill represents a thoughtful approach to address a pressing issue in a fair way. Montana policy makers should explore whether it is feasible to try to close the funding gap over a shorter time period, such as 30 years, and should think about using this opportunity to link contributions going forward with actuarial analysis from the state's pension plans. Closing the funding gap is a critical task for Montana and this proposal, while not the only way to do it, would put the state on a more fiscally responsible path.

But closing the funding gap without fixing the plan that allowed a funding crisis to emerge would be incomplete. When confronting an oil spill, it is important to both clean up the oil and cap the well. Policy makers in Montana need to look for a way to ensure that the plan being offered going forward is affordable, sustainable, and secure. The goal of this is not to reduce the projected amount that Montana pays for pension benefits for new workers—ultimately the employer contribution for those plans is relatively low. But that employer contribution is risky—if investments underperform, if salaries deviate from expectations, or if lifespans go up, suddenly tax payers might have to pay more than they bargained for. And since there is a disconnect between when pension promises get made under the current plan and when the bill actually comes due, it is easy for policy makers to underfund Montana's pensions, either deliberately or inadvertently.

Finally, traditional defined benefit pension plans are backloaded, meaning that workers who change jobs one or more times could be on a less secure path towards retirement than if they participated in one of the alternative defined benefit designs that are less backloaded or in a well-designed defined contribution plan.

Traditional defined benefit plans, where workers are promised a retirement benefit set as a proportion of their final salary, have been discussed in Montana and elsewhere. So have defined contribution plans, where workers receive a fixed contribution to an individual retirement account rather than a fixed benefit. Lastly, states like Georgia, Rhode Island, and Virginia have all adopted stacked hybrid plans that combine a less generous traditional defined benefit alongside an individual retirement account as a way to share risk and offer a more portable benefit to workers.

But I want to talk now in more detail about a way of designing a pension plan that is not as widely known. This plan structure, called cash balance, is a more modern way to offer a defined benefit to a workforce. Each worker has an individual retirement account and the benefit is determined by how much is in their account at retirement. Workers also receive two of the most important benefits from a traditional defined benefit: a guaranteed minimum benefit and a lifetime benefit. Public employers guarantee a minimum return on retirement assets, setting a floor for benefits rather than leaving that investment risk with individual workers. When times are good and investment returns are high, state and local governments keep some of the excess returns to pay for the guarantee. When workers finally retire, these plans need to give the option for workers to convert their retirement savings into an annuity, which provide an annual monthly benefit that will never run out, protecting retirees from outliving their benefits.

The most important thing is that a plan is well-designed, has adequate employer and employee contributions, and is consistently and fully funded. Any plan can work if it meets those criteria; and no plan will work if resources are insufficient. But cash balance designs are a good way of getting at some of the core problems with plan design. Risk is shared between workers and tax payers. Costs are transparent and predictable. And benefits aren't backloaded so a worker who switches careers several times would still have retirement security.

Policy makers need to consider all the options and all the tradeoffs. And they need to understand that closing the funding gap without fixing the plan going forward would be an incomplete approach—as would coming up with a new plan but doing nothing to help pay down the unfunded liability. Thankfully this remains a solvable problem. But, if policy makers delay, it could eventually become an unmanageable crisis.

These are hard choices facing you as well as policy makers across the 50 states. You have a responsibility to be fiscally prudent and help the state manage a growing bill that is crowding out needed public spending. You have a responsibility to be fair to current employees and retirees while at the same time knowing you may need to call on them to be part of shared sacrifice. You need to make sure that the system you put in place is robust and sustainable so policy makers don't have to come back to deal with this in five years or 15 years.

There is no one-size-fits-all solution and Montana policy makers will need to find an approach that works for the state. As you work to address this challenge, we can tell you that this remains a solvable problem and we can offer our help to make sure you have the data and analysis you need to make an informed decision.

In the end, it's not just about reducing costs in a state's retirement system; it's about designing a system that meets the state's needs while being both fiscally responsible and sustainable. And, it's about the fiscal discipline to pay for that benefit, because without fiscal discipline, nothing is sustainable.

Thank you for your interest and attention. We are available to help the legislature as you pursue this critically important project for the fiscal future of Montana. Thank you and we are looking forward to your questions.