

No. 126 – April 2010

The State Public Pension Crisis: A 50-State Report Card

By Eli Lehrer and Steve Stanek¹

1. Introduction

Taxpayers in almost every U.S. state owe large and possibly unpayable retirement pensions to the men and women who work for the government. The deep recession of 2008-2009 has moved up the day of reckoning, requiring immediate action by many states to avoid financial catastrophe.

While no one doubts that the people who police the streets, teach school, fight fires, plan roads, and administer government benefits deserve fair compensation for their labors, current public policy almost everywhere grants many public employees overly generous pensions that pose a large and growing burden on taxpayers. Even as many private employers have reduced or eliminated traditional pensions, they remain the norm for state government workers.

If large government pensions were part of a package that also included lower wages, they might be justified. But, on balance, government employees make more money than those in the private sector. According to the Bureau of Labor Statistics, average total compensation (wages and benefits) for government employees stands at \$39.83 an hour, while private-sector workers

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¹ Eli Lehrer is national director of the Center on Finance, Insurance, and Real Estate at The Heartland Institute. Steve Stanek is a Heartland research fellow and managing editor of *Budget & Tax News*. Longer bios appear on the back cover. They thank the following persons who assisted in research and peer review: Joseph Bast, Jesse Buggs, William Peirce, William Shughhart, and James Young. Any remaining errors are the authors' responsibility.

receive an average of \$29.40 an hour.² The average government employee, in other words, receives compensation worth almost \$83,000 a year, while the typical private-sector worker's compensation comes out to about \$61,000.

The largest single cause of this disparity is not wages (although they are higher in the government sector) or even health insurance but, rather, the size of public-sector pensions. Only about a fifth of private-sector workers qualify for any sort of pension, while nearly 80 percent of government workers do. And governments spend nearly five times more on pensions than their private-sector counterparts.³

One analysis puts the unfunded collective burden of these pensions at between \$750 billion and \$1.75 trillion.

Public employee pensions are expensive. One analysis puts the unfunded collective burden of these pensions at between \$750 billion and \$1.75 trillion.⁴ Unfunded liability is a measure of the shortfall between promised pension benefits and the ability of the pension fund to pay those benefits. For example, if the accrued

liability is \$5 billion and the value of assets is \$4 billion, the unfunded liability is \$1 billion. Dealing with these pension obligations represents a major challenge for the nation, its states, and its future.

With all this in mind, the present report has three goals:

- To draw attention to the enormous burdens public employee pensions pose in some locations;
- To create an objective way to measure and rank states according to the operation and relative disposition of the pension plans in the 50 states; and
- To suggest ways that states facing problems with their pension systems might go about solving these problems.

Part Two reviews the nature of the public-sector obligations and gives some evidence as to their size and fiscal risk. Part Three reviews and justifies the criteria we use to compare state pension plans. Part Four ranks all 50 states and every major public employee pension plan in the U.S. Part Five describes some reforms states could adopt to avoid the looming crisis. Part Six is a brief summary and conclusion. An Appendix contains tables showing enrollment of individual pension plans and how each plan scores on the six variables in the report card.

² Bureau of Labor Statistics, "Employer Costs for Employee Compensation," March 2010, <http://www.bls.gov/news.release/ecec.nr0.htm>.

³ Ibid. Private-sector companies spend 1.5 percent of payroll, on average, on defined benefit pensions, while governments spend an average of 7.3 percent.

⁴ Robert Novy-Marx and Joshua D. Rauh, "The Intergenerational Transfer of Public Pension Promises," National Bureau of Economic Research, September 2008, <http://www.nber.org/papers/w14343>.

2. The Public-Sector Pension Crisis

The challenge posed by rising public-sector pension costs is much larger than is commonly acknowledged; so large in fact that California, Illinois, New York, and other states face almost certain insolvency unless they adopt major reforms. Robert Novy-Marx and Joshua D. Rauh, in a paper for the National Bureau of Economic Research published in 2008, estimated the value of pension promises already made by U.S. state governments will grow to \$7.9 trillion in just 15 years.⁵

“We conservatively predict a 50% chance of aggregate underfunding greater than \$750 billion and a 25% chance of at least \$1.75 trillion (in 2005 dollars),” Novy-Marx and Rauh wrote. “Adjusting for risk, the true intergenerational transfer is substantially larger. Insuring both taxpayers against funding deficits and plan participants against benefit reductions would cost almost \$2 trillion today, even though governments portray state pensions as almost fully funded.”

Data Delusions

Bloomberg News reporter David Evans has highlighted the accounting games government pension funds play to make themselves look stronger than they really are.

“Public pension funds across the U.S. are hiding the size of a crisis that’s been looming for years,” he writes. “Retirement plans play accounting games with numbers, giving the illusion that the funds are healthy. The misleading numbers posted by retirement fund administrators help mask this reality: Public pensions in the U.S. had total liabilities of \$2.9 trillion as of Dec. 16 [2008], according to the Center for Retirement Research at Boston College. Their total assets are about 30 percent less than that, at \$2 trillion.”⁶

California, Illinois, New York, and other states face almost certain insolvency unless they adopt major reforms.

Novy-Marx and Rauh, in a paper published in 2009, describe the source of the problems Evans highlighted: “Government accounting rules currently obscure the true extent of public pension underfunding in the United States. In particular, Government Accounting Standards Board (GASB) ruling 25 and Actuarial Standards of Practice (ASOP) item 27 stipulate that public pension liabilities are to be discounted at the expected rate of return on pension assets. This procedure creates a major potential bias in the measurement of public pension liabilities. Discounting liabilities at an expected rate of return on the assets in the plan runs counter to the entire logic of financial economics: financial streams of payment should be discounted at a rate

⁵ Ibid.

⁶ David Evans, “Hidden Pension Fiasco May Foment Another \$1 Trillion Bailout,” Bloomberg News, March 3, 2009, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=alwTE0Z5.1EA>.

that reflects their risk (Modigliani and Miller (1958)), and in particular their covariance with priced risks (Treynor (1961), Sharpe (1964), Lintner (1965)).”⁷

They continue:

Our estimates focus on two primary measures, a taxpayer obligation measure and a default-free measure. We find the pension promises already made to state workers are underfunded by at least \$1.31 trillion as far as taxpayers are concerned, under the strong assumption that the state can default on these promises to the same extent that it can default on its general obligation debt. This is a conservative estimate because most state constitutions suggest that pension promises are higher in priority than general obligation debt. Furthermore, this estimate looks only at benefits accrued up until now under the ABO [accumulated benefit obligation], a narrow measure of the accrued liability. From the perspective of our default-free measure, which does not credit states for the ability to default, state pensions are underfunded by \$3.23 trillion.⁸

The difference between Novy-Marx and Rauh’s estimates and those reported by the states is largely (but not entirely) due to the use by most states of an 8 percent discount rate, a rate that Novy-Marx and Rauh call “far too high.”

According to public databases, more than 5,000 retired California government workers receive annual pension benefits exceeding \$100,000.

California: Lavish Benefits and Soaring Costs

Local and state governments across the country are already feeling the strain of trying to keep up with their pension obligations. One of the most stressed states is California, where the state’s annual pension

fund contribution has jumped from \$321 million in 2000–01 to \$7.3 billion in 2008–09.

According to public databases, more than 5,000 retired California government workers receive annual pension benefits exceeding \$100,000.⁹ And with pension benefits pegged to ever-rising salaries, future retirees can expect to receive far more than today’s retirees.

Ten California retirees currently receive more than \$220,000 a year in pension benefits. Topping the list is Bruce Malkenhorst, who retired in 2006 after a 27-year run as Vernon city

⁷ Robert Novy-Marx and Joshua D. Rauh, “Public Pension Promises: How Big Are They and What Are They Worth?” National Bureau of Economic Research, July 10, 2009, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1352608.

⁸ Ibid.

⁹ Ed Mendel, “CalPERS Actuary: Pension Costs Unsustainable,” *Calpensions*, August 10, 2009, <http://calpensions.com/2009/08/10/calpers-actuary-pension-costs-unsustainable/>.

administrator. He receives \$41,639 a month – \$499,674 this year.¹⁰ Not bad for having run a town of just 92 people that has no school, park, library, or grocery store. This “city” near Los Angeles is made up almost entirely of industrial properties. Malkenhorst was being paid \$600,000 a year when he retired. Local prosecutors later charged him with misappropriating \$60,000 of city money for personal use. That case is still working its way through the courts.¹¹

Many California cities allow employees to accrue a pension benefit of 3 percent of their final year’s salary for each year worked. So employees who spend 30 years on the job can retire with pensions that pay 90 percent of their final year’s salary. Most police and firefighters may retire at age 50. Similar retirement benefits are offered in most states.

San Diego teetered on the brink of insolvency in large part because of its lavish pensions, and last year Vallejo, California went into bankruptcy because of its lavish pay and perks. Ten Vallejo firefighters earned more than \$200,000 apiece last year, nearly four times Vallejo’s median family income of \$56,805, and they will be able to retire with 90 percent of their final year’s salary after 30 years of service. The city has a \$16 million annual budget and an unfunded pension liability of \$135 million.¹²

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At a seminar hosted by the *Public Retirement Journal*, the chief actuary for CalPERS, which runs California’s state pension system, told attendees: “We are facing decades without significant turnarounds in assets, decades of – what I, my personal words, nobody else’s – unsustainable pension costs of between 25 percent of pay for a miscellaneous plan and 40 to 80 percent of pay for a safety plan (police and firefighters). ... We’ve got to find some other solutions.”¹³

¹⁰ “Indicted Vernon official collecting \$500,000 annual pension,” *Los Angeles Times*, May 7, 2009, <http://latimesblogs.latimes.com/lanow/2009/05/for-years-bruce-malkenhorst-sr-reigned-as-the-highest-paid-city-official-in-california-riding-in-limousines-and-making-m.html>.

¹¹ Evan Hessel, “Welcome to Paradise,” *Forbes.com*, February 27, 2007, <http://www.forbes.com/forbes/2007/0226/104.html>.

¹² Steve Stanek, “High Labor Costs, Housing Slump Drive Calif. City into Bankruptcy,” *Budget & Tax News*, July 2008, <http://www.heartland.org/budgetandtax-news.org/article/23324/>.

¹³ Quoted by Ed Mendel, *supra* note 9.

New York's Mayor: "That Defies Common Sense"

In a letter published in the *New York Post* in December 2008, New York City Mayor Michael Bloomberg noted: "New York City is spending so much money on pensions – \$6.3 billion, a 10-fold increase from the \$695 million we spent in 2000 – that we have far less to spend on core services, such as public safety, education, parks, and senior centers. That defies common sense, and it's hurting our city. For instance, the city now has to spend more money on pensions and fringe benefits for firefighters than we pay in salaries for firefighters."¹⁴

"The city now has to spend more money on pensions and fringe benefits for firefighters than we pay in salaries for firefighters."

– Michael Bloomberg
Mayor of New York City

Bloomberg's point about having less to spend on core services must be stressed. Local and state governments cannot print money. Every dollar they spend on pensions is a dollar they cannot spend on something else ... and a dollar they must take from taxpaying citizens and businesses.

This summer former New York governor Eliot Spitzer noted that in New York State, "where the state pension fund lost

\$44 billion, or about 28 percent of its value, during the last year, local government contributions to the pension fund are going to have to triple over the next six years to make up the shortfall. Local governments will have to supply an extra \$5.5 billion per year. That tax burden alone – traditionally derived to a great extent from the property tax – could break the backs of many communities."¹⁵

On paper, New York State's pensions appear among the nation's most financially healthy in that they are fully funded. Nonetheless, they pose a significant burden on a struggling state. New York Gov. David Paterson repeatedly called for pension reform because pensions will cost the state almost \$50 billion over the next 30 years.¹⁶ A New York think tank has referred to the pension system as a "bomb" with a fundamentally flawed structure.¹⁷

¹⁴ Michael Bloomberg, "Why Pension Reform Is Fair & Vital," *New York Post*, December 18, 2008, http://www.nypost.com/seven/12182008/postopinion/opedcolumnists/why_pension_reform_is_fair_vital_144747.htm.

¹⁵ Eliot Spitzer, "State of Fear," *Slate*, July 13, 2009, <http://www.slate.com/id/2222776/>.

¹⁶ Reuters News Service, "New York Governor Urges Overhaul of State Pension System," June 3, 2009, <http://www.reuters.com/article/idUSN0356905520090603>.

¹⁷ E.J. McMahon, "Defusing New York's Pension Bomb," The Manhattan Institute, June 7, 2006, http://www.empirecenter.org/Special-Reports/2006/06/defusing_new_yo.cfm.

Illinois: A \$219.1 Billion Unfunded Liability

In Illinois, the state's unfunded pension liability calculated under GASB procedures exceeds \$85 billion. Novy-Marx and Rauh contend the GASB accounting method enables Illinois and other states to lowball liabilities. They put Illinois' true unfunded pension liability at an astonishing \$219.1 billion in 2009.¹⁸

Jeffrey Brown, writing for the Center for Business and Public Policy at the University of Illinois-Champaign, noted: "If the state of Illinois wanted to be certain it had enough money set aside today so that it could meet all public pension benefit obligations that have already been accrued, it would need to set aside an additional \$219.1 billion. For perspective, that is about 1/3 of Illinois GDP, about 1/3 of state revenues, and about four times the outstanding state debt."¹⁹

The Chicago-based Civic Federation studied 10 Chicago-area pension funds and the five state funds and concluded, "Data from the most recent audited financial statements of Illinois' state and local government pension funds show that the total unfunded liabilities for pensions supported by the taxes of Chicago residents reached \$10,037 per capita for fiscal year 2008."²⁰

The lavishness of pension promises is driving Chicago-area and state pension systems to take big risks with their investments.

In a separate report issued earlier in 2009, the Civic Federation noted how lavish pension promises are driving Chicago-area and state pension systems to take big investment risks:

Due to underfunding, pension plans have become overly dependent on high investment returns in an attempt to bridge funding shortfalls. High levels of equity exposure make local funds exceedingly vulnerable to market declines such as the current worldwide bear market. The major Chicago-area local governments' statutory pension contributions are set by state statute and are unrelated to how much money the funds need to cover their annual expenses. Thus, even good stock market returns such as those experienced in 2003-2006 have not been able to compensate for insufficient employer contributions. The funds' combined unfunded liability grew during each of those years and now stands at \$17.1 billion.²¹

¹⁸ Novy-Marx and Rauh, *supra* note 7.

¹⁹ Jeffrey Brown, "Why the Illinois Pension Funding Hole Is Even Deeper than You Think," October 13, 2009, <http://businesspublicpolicy.com/?p=226>.

²⁰ "Chicagoans, can you spare \$10,037?" Civic Federation, September 30, 2009, <http://www.civiced.org/civic-federation/blog/chicagoans-can-you-spare-10037>.

²¹ "Local Public Pensions in Trouble Before Recession and Stock Market Crash: Civic Federation," Civic Federation, March 30, 2009, <http://www.civiced.org/press-room/local-public-pensions-trouble-recession-and-stock-market-crash-civic-federation>.

New Jersey: Recent Reforms a Good Sign

New Jersey, one of the most union-heavy states in the country, has taken a leadership role in reforming employee benefit and pension systems. In March 2010, the New Jersey Legislature approved a package of state benefit cuts that increased employee contributions for health benefits, eliminated part-time employees' eligibility for pensions, and rolled back a series of expensive benefit increases approved in comparatively flush 2001.²² The state had little choice but to make these changes: Its unfunded pension liability stood at \$46 billion, the state had skipped a payment to the system, and the state pension fund lost \$17 billion in the fiscal year that ended in June 2009.²³ The changes, made after the data for this report card were compiled, aren't reflected in New Jersey's grade.

There are 22.5 million public-sector workers and retirees, most of them promised generous wages and benefits with payment guaranteed by state constitutions.

New Jersey's overall plan, which included underfunding its pension system by skipping contributions, won't necessarily serve the interests of all taxpayers in the long term, since any skipped contributions will have to be made up through higher taxes or more debt in the future. That said, the reforms do show that even states with strong government unions can and do make sometimes-painful

changes in their pension systems. While the state may not be a model in every respect, New Jersey's actions could represent the beginning of a positive trend.

A National Problem

The problem may be most acute in states like California, Illinois, and New York, but it is truly a national problem. *Forbes'* Stephanie Fitch observes there are 22.5 million public-sector workers and retirees, most of them promised generous wages and benefits with payment guaranteed by state constitutions. At the present time of economic distress, their retirement benefits present a genuine issue of fairness. Fitch writes:

In private-sector America your job, assuming you still have one, hangs on the fate of the economy. If your employer ever offered a pension for life, like young officer Goss is receiving, odds are it has stopped doing so, or soon will. Those retirement accounts you scrimped and saved to assemble? Unless they are invested in Treasuries, they aren't doing too well. In private-sector America the math leads to the grim prospect of working longer and living poorer.

²² Gina Chon, "New Jersey Cuts Workers' Benefits," *The Wall Street Journal*, March 24, 2010.

²³ *Ibid.*

In public-sector America things just get better and better. The common presumption is that public servants forgo high wages in exchange for safe jobs and benefits. The reality is they get all three. State and local government workers get paid an average of \$25.30 an hour, which is 33% higher than the private sector's \$19, according to Bureau of Labor Statistics data. Throw in pensions and other benefits and the gap widens to 42%.²⁴

The difference in retirement and health benefits between public- and private-sector workers is striking. In February 2009, the Chicago Federal Reserve Bank and the Civic Federation, a public policy organization in Chicago, hosted a forum that examined the differences in wages and benefits between the government sector and private sector and discussed best practices in workforce sustainability. The subsequent paper on that forum cited the U.S. Bureau of Labor Statistics' September 2008 Employer Costs for Employee Compensation (ECEC) survey, which showed the employer cost per hour for benefits is \$7.93 in the private sector and \$13.41 in the government sector.²⁵

Public-sector retirement benefits, unlike their private-sector counterparts, almost everywhere involve "defined benefits" rather than "defined contributions." A defined benefit plan guarantees workers a specific sum of money, often paid monthly, after working for an employer for a certain period of time. A defined contribution plan, on the other hand, involves the employer (usually with a required employee "match") giving employees a specific "up front" sum for a retirement account and leaving the employee to manage it. In the private sector, defined contribution pensions are typically called 401(k)s (for profit-making companies) and 403(b)s (for non-profits.)

Public-sector retirement benefits, unlike their private-sector counterparts, almost everywhere involve "defined benefits" rather than "defined contributions."

Both plan types have advantages and disadvantages for workers and taxpayers. Defined benefit plans are often better and easier to manage for government workers who plan to stay in the same job for a long time. For public-sector employees who work in professions (police officer, firefighter, corrections officer, government benefits administrator) that have few or no equivalents in the private sector, staying put in the same job is often a given. For these workers, a defined benefit pension can guarantee them a sizeable portion of their pre-retirement income while requiring no personal effort or risk. At least in the short term, taxpayers may appear to be better off under a system of defined benefit pensions since defined benefit pensions don't have to be paid until some point in the future. A government that provides them can underfund them and tax less or provide more services.

²⁴ Ibid.

²⁵ "Public and Private Sector Compensation: What Is Affordable in this Recession and Beyond? – A Conference Summary," *Chicago Fed letter*, Number 262a, May 2009, http://www.chicagofed.org/publications/fedletter/cflmay2009_262a.pdf.

On balance, defined benefit pensions pose a significant risk to taxpayers. Since the benefits are guaranteed (and, almost everywhere, are protected under either state constitutions or union contracts), taxpayers are liable for paying the pensions whenever contributions and pension fund earnings fail to cover the benefits owed to current retirees.²⁶ Workers don't always benefit from defined benefit pensions either. With a few exceptions, defined benefit pensions don't vest – become eligible to pay employee benefits – until an employee has spent a significant amount of time on the job. In many states, employees who spend less than 10 years in a government job walk away with nothing or eligibility for a “cash-out” that leaves them with less than they would receive under a defined contribution system.

How did the gap between private and government pension benefits become so wide?

How did the gap between private and government pension benefits become so wide? Some types of government work, particularly in the public safety realm, may appear particularly deserving of generous wages and pensions. Police officers and

firefighters, for example, do jobs that often require significant physical skills that fade with age and have few identical employment opportunities in the private sector. But it is worth noting that firefighters do not appear, and police officers rank only tenth, in the list of 10 occupations most likely to result in serious injury or death, behind cab drivers, lumberjacks, professional fishermen, farmers, and iron workers, among other not-uncommon occupations.²⁷ Most government workers work indoors, face no more job-related risks than workers in the private sector, and perform services similar to private-sector workers.

The most likely causes for the disparity are incentives faced by elected officials and government department heads.²⁸ Defined benefit plans allow them to give in to worker demands for more generous benefits without having to ask taxpayers to pay more, at least not *right away*. When the bill comes due, many of the department heads who granted the increases and the elected officials who approved them expect to be retired or out of office. It is a temptation that too few government officials have been able to resist.²⁹

Adding to government officials' incentive to promise lavish retirement benefits is the power of public-sector unions. According to U.S. Department of Commerce data, 37.4 percent of public-sector employees were represented by labor unions in 2009, compared with only 7.2 percent of

²⁶ Darryl B. Simko, “State Constitutional Contract Protections and Fiscal Constraint of Public Pensions,” *Temple Law Review*, 1996: 1059.

²⁷ “Ten Most Dangerous Jobs,” Safety Services Company, July 27, 2009, citing Bureau of Labor Statistics, <http://www.safetyservicescompany.com/blog/10-most-dangerous-jobs-3>.

²⁸ See “The Impact of Surplus Sharing on the Portfolio Mix of Public-Sector Defined Benefit Pension Plans: A Public Choice Approach,” *Public Choice* (2009) **140**: 161-184.

²⁹ Leslie E. Papke and J. Fred Giertz, “Public Pension Plans: Myths and Realities for State Budgets,” *National Tax Journal*, June 2007, <http://www.britannica.com/bps/additionalcontent/18/25977867/Public-Pension-Plans-Myths-and-Realities-for-State-Budgets>.

private-sector employees.³⁰ The Employee Benefits Research Institute observes that public-sector unions exercise their influence “directly where bargaining over benefit issues is allowed, but it is also exercised indirectly through the legislative process.”³¹ Union campaign contributions, volunteers, and votes undoubtedly influence the decisions of elected officials, once again rewarding those who vote for generous benefits today and leave taxpayers to foot the bill *after* they leave office.

3. How to Grade Public Pension Systems

Although structures and eligibility differ from state to state, the single most common structure consists of a Teachers Retirement System (TRS) and an Employee Retirement System (ERS), sometimes called a Public Employee Retirement System (PERS). Most states maintain separate, much smaller, pension systems for judges and elected officials. Likewise, larger localities often have their own pension systems independent of state pension systems. This report does not evaluate these smaller statewide and non-statewide systems.

We were limited to the data that could be compared nationally, which meant using data based on the state of pension plans in 2008 and not including 2009 data. We relied heavily on data collected by the Wisconsin Legislative Council and presented in “2008 Comparative Study of Major Public Employee Retirement Systems,” published in December 2009.³² This remarkably thorough report has been prepared every two years since 1982 and (since 2008) includes data from 85 public employee retirement systems.

We chose six variables to compare, score, and then rank all 50 state plans:

- (1) Employee contribution
- (2) Choice of retirement plan
- (3) Taxable benefits
- (4) Time before vesting
- (5) Earnings basis for pensions
- (6) Fund solvency

We chose six variables to compare, score, and then rank all 50 state plans:

- (1) *Employee contribution*, the amount employees must contribute to their own pensions relative to the taxpayer subsidy.

³⁰ David Denholm, “Unions Flood Public Sector, Drain Away from Private Sector,” *Budget & Tax News*, forthcoming June 2010, <http://www.heartland.org/budgetandtax-news.org/article/27226/>.

³¹ “The Public-Sector Environment,” Employment Benefits Research Institute, http://www.ebri.org/pdf/publications/books/fundamentals/2009/41_Environ_PUB-SCT_Funds-2009_EBRI.pdf.

³² Daniel Schmidt, “2008 Comparative Study of Major Public Employee Retirement Systems,” Wisconsin Legislative Council, December 2009, http://www.legis.state.wi.us/lc/publications/crs/2008_retirement.pdf.

- (2) *Choice of retirement plan*, whether employees have a choice of defined benefit or defined contribution plans.
- (3) *Taxable benefits*, whether states tax public pension benefits as income when they are paid.
- (4) *Time before vesting*, how many years workers must serve before they are entitled to pensions.
- (5) *Earnings basis for pensions*, which years or how many years of earnings are used as the basis for determining the size of pensions.
- (6) *Fund solvency*, reported funds on hand as a percentage of expected liabilities, relative to other states.

The first five variables concern the kinds of promises states make to public-sector workers. The final variable, fund solvency, concerns the ability of states to keep the promises they make. In each category, plans that take actions we consider good for taxpayers and states' fiscal futures receive bonus points, while plans that take actions we consider bad for taxpayers and financially unsustainable for states have points taken away.

The first five variables concern the kinds of promises states make to public-sector workers. The final variable, fund solvency, concerns the ability of states to keep the promises they make.

The greatest weight went to variables most likely to affect taxpayers: the size of the contributions made from tax dollars and the overall funding of the plan. On most variables, most states fall in the 10-point range between +5 and -5 and the modal score (the score assigned to the largest number of states) is zero. We give one variable, the earnings basis for pensions, double weight and another variable, fund solvency,

quadruple weight. (We weight by assigning additional points to the variables in the base scores.) We single out these two variables because the earnings basis for pensions is the single most important promise made to employees in terms of determining cost, and a state's solvency measures a state's ability to keep the promises it makes.

The rest of this chapter summarizes why we picked these variables and how we rewarded or withdrew points.

1. Employee Contribution

Defined benefit pensions are funded by contributions from both the employer and the employee. Pension experts generally recommend that employers and employees contribute roughly equal amounts to the pension system. Girard Miller, a senior strategist for retirement plans and

investments at the PFM Group, wrote recently for *Governing* magazine:

The ideal ratio of employer-employee cost shares for retirement benefits is a number close to 50-50. There is no automatic best answer, because sustainable retirement benefits may be affordable for some employers with a lower rate of employee contributions. But generally speaking, there is no justification for any public employee paying less than one-third of his true costs of retirement plan benefits.³³

Miller also notes, “few public employers have insisted on equal shares, and many have drifted mindlessly in the opposite direction. In some cases, the employers are paying the entire employees’ share of pension costs, as well as the employer contributions, and requiring nothing for retiree medical (OPEB) benefits either.”³⁴

For this report, we reward plans with five points if they require employees to pay even a small amount more than taxpayers, treat neutrally (zero points) those that have dollar-for-dollar matches, and penalize by up to 15 points those that require significant taxpayer subsidies. For each plan, we divided the employer cost by the employee cost to determine the ratio of taxpayer subsidy to employee contribution. Table 1 summarizes the scoring method.

| Table 1. Variable 1 – Employee Contribution | |
|--|--|
| Points | Measurement |
| -15 | Taxpayer subsidy more than 2 times the employee contribution |
| -10 | Taxpayer subsidy is modest contribution but no employee contribution required |
| -8 | Taxpayer subsidy more than 1.5 times the employee contribution but less than 2 times the employee contribution |
| -5 | Taxpayer subsidy less than 1.5 times the employee contribution but more than 1.1 times the employee contribution |
| 0 | Taxpayer subsidy essentially equal to the employee contribution (between .9 and 1.1 times the employee contribution) |
| +5 | Taxpayer subsidy less than .9 percent of the employee contribution |

A few states presented special cases: For plans that offered a range of possible contributions, we averaged the range and used that to determine the final score. Where statutes, legislative choices, or yearly investment returns decide the size of the employer contributions, we assigned a score

³³ Girard Miller, “Employer Paid Humbug,” *Governing Magazine*, December 3, 2009, <http://www.governing.com/column/employer-paid-humbug>.

³⁴ Ibid. OPEB stands for “other post-employment benefits.”

of zero. Plans to which we've assigned zero in this manner may not have employee contribution levels that are comparable to those of other plans with the same score.

2. Choice of Retirement Plans

No single type of retirement plan is most appropriate for every employee or would be the best deal for taxpayers. Although we contend taxpayers generally get the best deal from defined contribution plans, we recognize that obstacles exist to changing plans in some cases and that savings to taxpayers could take many years to materialize. (This is discussed in more depth in Part Five.) At a minimum, though, states ought to give employees a choice of defined benefit or defined contribution plans as their primary pension plan.

We scored plans that do not offer a choice of primary pension plan "0" and those that offer a choice of primary pension plan +5. Table 2 summarizes the scoring method.

| Table 2. Variable 2 – Choice of Retirement Plan | |
|--|--|
| Points | Measurement |
| 0 | Does not offer a choice of defined contribution or defined benefit plans |
| +5 | Offers a choice of defined contribution or defined benefit plans |

3. Taxable Benefits

The federal government and virtually all states tax income from private pensions. Fairness dictates that states should do the same to income from public pensions. Failing to do so amounts to a hidden increase in public-sector compensation, another way for elected officials and department heads to avoid accountability for expensive concessions to public-sector workers.

We reward states that tax public pension benefits like other income and penalize states that grant them tax exemptions. So as not to unfairly penalize states that have no income tax, we give them a score of +1 rather than -5. Table 3 summarizes the scoring method.

| Table 3. Variable 3 – Taxable Benefits | |
|---|---|
| Points | Measurement |
| -5 | Plan benefits exempt from all state income taxation |
| -3 | Plan benefits partly exempt from state income taxation with a deduction of \$10,000 or more |
| 0 | Plan benefits partly exempt from state income taxation with a deduction less than \$10,000 |
| +1 | State has no income tax |
| +5 | Plan benefits fully taxable |

4. Time Before Vesting

If governments offer defined benefit pensions, they should offer them to employees who spend a sizeable portion of their career with the government. Taxpayers shouldn't be liable for lifetime benefits paid for people who work for the government only a short time. Most private-sector employers who offer pension plans allow employees to “vest”– become eligible for a pension – after five years on the job, with the amount of the pension then increasing with years of service.

For this report, we penalize states that allow employees to vest immediately and reward those that have longer vesting periods. Table 4 summarizes the scoring method.

| Table 4. Variable 4 – Time Before Vesting | |
|--|--|
| Points | Measurement |
| -5 | Plan vests immediately |
| -3 | Plan vests in 3 years |
| -1 | Plan vests in 4 years |
| 0 | Plan vests in 5 years, is pure defined contribution, or uses a varying scale where most participants vest in 5 years |
| +3 | Plan vests in more than 5 years but less than 10 years |
| +5 | Plan vests in 10 years |

5. Earnings Basis for Pensions

Most defined benefit pensions base a pension on some fraction of employees' earnings during their careers. A common abuse of public-sector pension plans is "spiking" pensions by deferring vacation, working extra overtime, and gaining last-minute promotions to artificially inflate salary in a worker's final year, a practice that can add hundreds of thousands of dollars to the cost of a single worker's retirement benefits.³⁵

The way to avoid "spiking" without discouraging hard work and legitimate late-career promotions is to base pension amounts on the average salary over a relatively long period, say five years or longer. The worst policy is to base pensions on the single highest year's earning. We therefore penalize states that facilitate spiking and reward those that discourage it, using the scoring method shown in Table 5.

| Table 5. Variable 5 – Earnings Basis for Pensions | |
|--|---|
| Points | Measurement |
| -10 | Plan bases pension on highest single year's earnings |
| -8 | Plan bases pension on highest three years out of 10 years' earnings |
| -5 | Plan bases pension on highest three years straight |
| 0 | Plan bases pension on highest four years (in any manner) |
| +5 | Plan bases pension on highest five or more years |

6. Fund Solvency

Well-run pension plans should be capable of paying the benefits they promise. Because of poor policy choices (captured, we hope, by the first five variables), most public pension plans will have to either increase mandatory contributions, greatly improve investment returns, take more from taxpayers, or reduce benefits if they are to remain solvent.

To determine the plans' relative solvencies, we relied on the plans' own reports of "funding ratios" (funds on hand as a percentage of the promised benefits they could reasonably expect to pay) under Government Accounting Standards Board (GASB) criteria. We ranked plans by quintiles, with the first quintile being the closest to fully funded and the fifth being the farthest from solvency. We gave additional points to plans that were 100 percent or more funded and penalized plans that were less than 50 percent funded. Table 6 presents the scoring method.

³⁵ Ed Mendel, "Public pension 'spiking' targeted in new legislation," *Capitol Weekly*, February 25, 2010, http://www.legis.state.wi.us/lc/publications/crs/2008_retirement.pdf. See also Ted Costa's "30 ways to spike your pension" list at <http://www.pebc.ca.gov/images/files/TedCosta070828.pdf>.

Table 6.
Variable 6 – Fund Solvency

| Points | Measurement |
|--------|--|
| -25 | Plan is less than 50 percent funded under GASB calculations or is defined contribution |
| -15 | Plan is in the fifth quintile of funding |
| -7 | Plan is in the fourth quintile of funding |
| 0 | Plan is in the third quintile of funding |
| +7 | Plan is in the second quintile of funding |
| +15 | Plan is in the first quintile of funding but less than 100 percent funded |
| +20 | Plan is 100 percent or more funded |

Limitations of This and Any Report Card

In principle, we would have liked to penalize plans that allow employees to retire “too early” with “too many” benefits, but we couldn’t find a good way to quantify this. We faced three problems:

- With two exceptions – both in Nebraska – plans don’t have a uniform “retirement age” but rather separate and often-conflicting formulas for different classes of workers as well as “normal” and “early” retirement programs. Thus, there was no clear retirement age we could compare among plans.
- What “too early” means differs by profession, and there is an enormous diversity of professions of people eligible for government pensions. Few 60-year-olds can perform the physical feats necessary to work as firefighters, while those who teach school or do social work may well be at the top of their professional abilities at that age. Private employers in different sectors have different retirement ages (although, with a few exceptions, mandatory retirement is forbidden in the private sector) and, in concept, it’s appropriate that governments can and should do the same.
- The question of what constitutes “too many” benefits was difficult to judge in the context of early retirement. By giving rewards and penalties to plans based on their salary calculation rules, we think we’ve captured this aspect of the problem of overly generous states.

Many evaluations of public-sector pension plans have cast doubt on the Government Accounting Standards Board methods used by the plans to report funding ratios and other relevant financial

information.³⁶ These methods differ from the Generally Accepted Accounting Principles private businesses use, and they may understate the true size of the obligations. Short of doing a full study of each pension fund's internal controls, there's no way to evaluate whether a given pension plans' accounting assumptions are accurate. By awarding points to plans that offer a choice of a defined contribution plan, this report favors plans that make no accounting assumptions at all. But the report makes no effort to reward (or punish) individual plans for their underlying accounting assumptions.

Some states have exacerbated existing pension plan ills through mismanagement of disability benefit systems, poorly structured buyout proposals, and badly designed retention mechanisms. There's no way to capture the flaws in the design of these mechanisms and no national data that allow objective comparisons among states.

Moreover, this report doesn't attempt to assess the quality of pension fund managers or re-audit the data on which the report is based. Insofar as some pension fund managers might falsify data, engage in fraud, or simply fail to fulfill their fiduciary duties, our study does not capture it.

Plans that we rank poorly may not pose imminent problems for the states that run them, while some plans with middling rankings may pose enormous problems due to the state's overall financial health.

Finally, but very importantly, this ranking attempts to evaluate retirement plans themselves, not the context in which they operate. Plans that we rank poorly may not pose imminent problems for the states that run them, while some plans with middling rankings may pose enormous problems due to the state's overall financial health. A state with a good bond rating, few burdensome public employee contracts, and no

constitutional prohibitions on changing its pension system may be able to fix a seriously broken pension system rather easily, while a state in different circumstances may face major problems with a system that appears less bad on paper.

A comparison of two states can help illuminate this limitation. Notoriously troubled California, where pensions are a major political issue, receives a "B" grade in our report card. While the state's pension system needs reform, its problems are particularly severe and worthy of attention now because the state's other fiscal problems are so severe. California has some of America's highest taxes, has already cut a number of services deeply, has an enormous gap in its budget, and has the nation's worst bond rating. As a result, fraud and waste in its public-sector pensions pose a major problem for the state even though the state's pension system, analyzed in isolation by our measures, is slightly better than the norm.

³⁶ George Passantino and Adam B. Summers, "The Gathering Pension Storm: How Government Pension Plans Are Breaking the Bank and Strategies for Reform," Reason Foundation, June 16, 2005, <http://reason.org/news/show/127599.html>, 9-11.

Utah, on the other hand, receives a “D” grade (on the verge of an “F”) even though state employee pensions have not been a major issue there. While Utah faces a budget gap just like other states, it’s a well-governed state with a AAA bond rating and modest taxes. While Utah needs to do something about its public-employee pensions, it has many more options than California does.

In short, pension reform matters for all states, but it’s not as urgent or as easy in every state, something this report card cannot capture.

4. A 50-State Report Card

To calculate each plan’s score, we added together the points awarded or subtracted for each variable. The raw numbers scored were weighted equally, since we weighted the factors by assigning more points to some and less to others.

Where states have more than one pension system, the state’s ranking is based on an average of the systems with each plan weighted by the fraction of the state’s total number of public pension plan participants it enrolls. As a result of this method, some states with troubled pension plans that need reform can still receive above-average grades if their other pension plans are particularly well-administered and solvent.

To assign grades to states, we calculated the standard deviation (the average distance from the mean) and assigned grades (without pluses and minuses) to states based on their distance from the mean. By grading on a curve in this manner, we award grades from “A” to “F.” For the data we compiled, the standard deviation was 14.13 and the mean was -4.47. This grading system is summarized in Table 7.

| Grade | Score | Measurement |
|--------------|------------------|--|
| A | 9.66 or higher | More than one standard deviation above the mean |
| B | -4.47 to 9.65 | Above the mean by less than one standard deviation |
| C | -18.6 to -4.47 | Below the mean by less than one standard deviation |
| D | -26.66 to -18.6 | Below the mean by more than one standard deviation but less than 1.5 standard deviations |
| F | less than -26.66 | Below the mean by more than 1.5 standard deviations |

Table 8 reports the states’ scores, ranks them from highest to lowest, and assigns them letter grades. Two tables in the appendix identify the scores for each of the six variables recorded by

each state pension plan and the enrollment data used to weight plans in states with two or more public pension plans.³⁷

| State | Letter Grade | Score | State | Letter Grade | Score |
|----------------|---------------------|--------------|----------------|---------------------|--------------|
| Alaska | A | +26.00 | Rhode Island | C | -5.00 |
| Florida | A | +24.00 | Massachusetts | C | -7.00 |
| North Carolina | A | +23.70 | Kentucky | C | -9.85 |
| Washington | A | +21.00 | Georgia | C | -9.87 |
| North Dakota | A | +18.24 | Iowa | C | -10.00 |
| Oregon | A | +15.00 | Nevada | C | -11.00 |
| Nebraska | A | +12.50 | Wyoming | C | -12.00 |
| Delaware | A | +12.00 | Virginia | C | -13.00 |
| Texas | B | +7.60 | New Jersey | C | -13.41 |
| Minnesota | B | +6.13 | Mississippi | C | -17.00 |
| South Dakota | B | +5.00 | Arkansas | C | -17.12 |
| Wisconsin | B | +5.00 | Alabama | D | -18.16 |
| Ohio | B | +4.50 | Connecticut | D | -18.28 |
| Indiana | B | +2.65 | West Virginia | D | -18.76 |
| Montana | B | +2.19 | Utah | D | -19.00 |
| Michigan | B | +1.93 | Maine | F | -20.00 |
| Vermont | B | 0.33 | New Hampshire | F | -20.00 |
| California | B | 0.12 | Maryland | F | -23.00 |
| Idaho | B | -1.00 | Colorado | F | -23.00 |
| New Mexico | B | -2.23 | South Carolina | F | -23.00 |
| Pennsylvania | B | -2.28 | Oklahoma | F | -24.31 |
| New York | B | -2.73 | Illinois | F | -24.50 |
| Tennessee | B | -3.00 | Hawaii | F | -25.00 |
| Missouri | B | -4.33 | Louisiana | F | -25.16 |
| Arizona | C | -5.00 | Kansas | F | -28.00 |

³⁷ An Excel spreadsheet containing all of the data and formulas used to generate the scores is available from the authors upon request.

Some highlights from the “report card” include the following:

- The five states with the highest-scoring public pension systems are Alaska, Florida, North Carolina, Washington, and North Dakota. Three other states (Oregon, Nebraska, and Delaware) also received “A” grades.
- The five states with the lowest-scoring public pension systems are Kansas, Louisiana, Hawaii, Illinois, and Oklahoma. Five other states (South Carolina, Colorado, Maryland, New Hampshire, and Maine) also received “F” grades.
- New York and California – states where concern over the status of public pensions runs high – both receive “B” grades. Illinois received an “F” grade. As explained earlier, financial problems in states such as New York and California have magnified the consequences of pension systems that are, on the basis of this review, slightly better than average.
- States at both ends of the grade spectrum defy characterization as mostly urban or rural, large or small, high-tax or low-tax, or even “Red” or “Blue.” This suggests those factors don’t determine or predict a states’ pension policies, and are neither excuses for nor defenses against poor public-pension policies.

Given the precarious nature of almost all state pension plans, it’s important to note that a good grade should not be considered a clean bill of health for a state’s pension systems. Although we feel confident in saying the systems that receive “A” grades are reasonably well-run and unlikely to imperil

their states’ overall fiscal health, we believe nearly all of the pension systems graded B and below are unsustainable and need some sort of reform. Many states that receive good grades still underfund their pension systems and operate them under rules that hurt taxpayers.

We believe nearly all of the pension systems graded B and below are unsustainable and need some sort of reform.

5. Directions for Reform

Public employee pensions imperil the fiscal health and future of many states. They impose great and perhaps un-payable costs on taxpayers. How should they be changed to protect taxpayers while still providing fair and sufficient retirement benefits for government workers?

Limiting public-sector retirement benefits isn’t a silver bullet for solving the current financial problems facing states such as California, Illinois, and New York. State constitutions and union contracts can make changing pension systems difficult, and the financial benefits of reform can be slow to arrive while transition costs can occur immediately. However, there are several things

states can do to improve their pension systems to provide long-term, if not short-term, relief to taxpayers and avoid what would otherwise be almost certain bankruptcy.

For obvious reasons, the reform recommendations that follow track our choice of variables used to rank and then grade states. States that adopt these reforms would see their ranking on this report card rise.

The specific steps necessary to implement reform will be different for each state.

We emphasize these are general directions for reform. The specific steps necessary to implement reform will be different for each state. In some states, reform would require only directing the public's attention to the problem and finding the political will to

address it. In other states, statutory or perhaps even constitutional changes might be required. Though we might wish it were otherwise, there's no single set of steps we can recommend.

1. Increase Employee Contributions

It seems that a fair rule of thumb would be that government workers should contribute at least as much toward their retirement as taxpayers. In reality, plans in Illinois, Georgia, Maryland, and Oklahoma require taxpayers to put up *four or more times* as much as government workers. New York has a plan that makes taxpayers put up three times as much, and at least eight other plans require taxpayers to put up twice as much as workers. These estimates are probably low because amounts designated as employee contributions for accounting purposes are sometimes actually paid by the employer.³⁸

We have acknowledged that if government workers were paid less than their private-sector counterparts, or if years of service in government left them unsuited for jobs in the private sector, then generous taxpayer contributions to public pensions might be justified. But government workers in fact generally receive higher wages than their private-sector counterparts, and the practice of offering generous pensions extends far beyond those professions that lack private-sector positions that require comparable skills and experience.

Roughly half of all pension plans require taxpayers to contribute more than employees. This is unfair and needs to change. Employees should pay, at minimum, half the cost of their own pensions.

2. Move to Defined Contribution Plans

Reason Foundation researchers George Passantino and Adam Summers note, "Over the past several decades, the private sector has rapidly shifted away from defined-benefit plans and

³⁸ Wisconsin Legislative Council, *supra* note 32, p. 19.

toward defined-contribution plans for good reason – traditional plans are expensive, unpredictable, and unsustainable in the long run.”³⁹

Defined benefit plans put virtually no risk on the workers or retirees, because taxpayers must make up any funding shortfalls. In contrast, defined contribution plans such as 401(k)s require the employee to set aside money (often, but not always, with contributions from employers) and determine how the money should be invested. The amount available for retirement depends on how much money was set aside and the success of the investments. The risk is on the workers.

The number of U.S. businesses that offer defined benefit plans has dropped to about 38,000 compared with more than 114,000 in 1983, according to the IRS. Yet they remain the standard benefit for government workers.

The number of U.S. businesses that offer defined benefit plans has dropped to about 38,000 compared with more than 114,000 in 1983, according to the IRS.⁴⁰ Yet they remain the standard benefit for government workers.

Nevertheless, Alaska, the District of Columbia, Michigan, and West Virginia now have defined contribution plans as primary plans for at least some state and local workers, such as teachers. Nebraska had a defined contribution plan as the primary retirement vehicle from 1967 to 2002. It was closed to new employees in 2003 and replaced with a cash balance plan. According to a recent report from the National Conference of State Legislatures (NCSL),

In the Nebraska cash balance plan, employees contribute between 4.3% and 4.8% of salary and the employer contributes about 7.5% of salary to an employee account. The employee cannot control investment of the account but is guaranteed an annual return of at least 5% a year. The account can receive a higher return, depending on investment earnings. At retirement, the employee may buy an annuity, or withdraw the balance in a lump sum or in installments. Principal differences from a defined contribution plan are the employer’s guarantee of a minimum investment return and control of investments.⁴¹

In Colorado, Florida, Montana, North Dakota, Ohio, and South Carolina, new employees have the option of joining a defined contribution plan or a defined benefit plan. There is limited ability to switch from one to the other. Florida, Georgia, Indiana, Ohio, Oregon, and Washington also offer hybrid plans that combine elements of defined contribution and defined benefit plans. All

³⁹ Passantino and Summers, *supra* note 36.

⁴⁰ “Choosing a Retirement Plan: Defined Benefit Plan,” Internal Revenue Service, <http://www.irs.gov/retirement/article/0,,id=108950,00.html>.

⁴¹ Ronald Snell, “State Retirement System Defined Contribution Plans,” National Conference of State Legislatures, September 2009, www.ncsl.org/Portals/1/Documents/.../StateGovtDCPlansSept2009.pdf.

states offer optional deferred compensation plans to augment primary pension coverage.⁴²

Advantages of defined contribution plans to workers include the ability to move money they put into the plan into a new plan if they switch jobs, more control over how much money is taken from their paychecks to fund the plans, access to retirement funds immediately rather than after several years until the worker is “vested,” and no risk of losing money contributed to a retirement account if a person goes into a new career before he or she is vested and eligible for retirement benefits.

The advantages of defined contribution plans are many, but shifting to such plans is not a silver bullet.

Actuarial and employee benefits consulting firm Milliman, Inc. reports where new hires have the choice of defined benefit (DB) or defined contribution (DC) plans, “the percentage of new employees electing DC plans ranges from 3 percent in the Ohio

Public Employee Retirement System to 26 percent in Florida.”⁴³ The Milliman report adds, “many of the members going into a DB plan never submit an election and are placed in the DB plan by default. However, based on survey data, Florida found that ‘up to 45% of the defaulters may be using this option as their active election in the belief that by defaulting there could be no mistakes made in their plan choice.’” In the Washington retirement system – the only one where defined benefit is not the default option – more than 60 percent of new members have enrolled in the defined benefit plan.

Shifting to defined contribution plans is not a silver bullet. The Milliman report notes that in 1991 the underfunded teachers pension system in West Virginia was closed to new members and new hires were put into a defined contribution plan. In 2005 the state flipped and started putting all new hires into the defined benefit system. Among other problems, unfunded obligations for existing members are not reduced when new members go into a defined contribution plan, and contributions from new members do not come in. Also, the battering the stock market took when the dotcom bubble burst in 2000-2001 hurt the ability of several thousand teachers to afford retirement, putting pressure on lawmakers to protect teachers from investment losses.

West Virginia projects a \$1.2 billion savings over 30 years from moving new hires from the defined contribution to defined benefit plans. But that projection relies on a 7.5 percent investment return.⁴⁴ As we’ve already noted, many analysts believe projections of such long-term gains are too rosy.

⁴² Ibid.

⁴³ Mark Olleman, “Public plan DB/DC choices,” *PERiScope* newsletter, Milliman, Inc., January 2009, <http://www.milliman.com/expertise/employee-benefits/publications/peri/pdfs/PERi-01-01-09.pdf>.

⁴⁴ Ibid.

On the other hand, many analysts support moves to put government employees into defined contribution plans in the belief they bring lower and more predictable costs. In Illinois, for example, the Governor’s Pension Commission in 2004 recommended additional study of a plan to replace all or part of the state’s defined benefit plans with defined contribution plans.

“Defined contribution plans can significantly reduce unfunded liabilities,” the commission report noted. “Once the State gets the current pension debt levels under control, a Defined Contribution Plan should be strongly considered in the near term for newly hired employees and current employees who voluntarily opt out of defined benefit programs.”⁴⁵

“Defined contribution plans can significantly reduce unfunded liabilities.”

– Illinois Governor’s Pension Commission

3. Tax Public Pension Benefits

Public pension benefits are subject to state income taxation, and no specific amount of retirement benefits is tax exempt, in 23 of the 87 plans covered by the Wisconsin Legislative Council survey.⁴⁶ Twenty-one plans are totally exempt from state income taxation, and 11 plans are in states with no state income taxes.

Exempting public pension benefits from state taxes often seems at the time to be an easy way to help “underpaid” government workers and perhaps to attract qualified people to the public sector. The favor does not show up in personnel budgets as an expense, and the true cost of the decision isn’t realized for many years. But from the standpoints of both fairness and state fiscal solvency, the tax exemption is no different from boosting public pensions by the income tax rate. In states with high income taxes, such as New York, this is equivalent to boosting pensions by 10 percent or more.

The state tax exemption for public pension benefits is often a “perk” not guaranteed by contracts or the state constitution. It should be the “first thing to go” as states tighten their fiscal belts and bring public pension spending under control.

4. Extend Vesting Periods

The idea of lifetime employment by a single employer disappeared from the private sector many years ago as both employers and employees realized it was inefficient and unfulfilling. It lives on in the public sector, however, at considerable expense to taxpayers.

⁴⁵ “Pension Reform Report and Recommendations,” Governor’s Pension Commission [Illinois], www.state.il.us/.../Pension%20Commission%20Final%202.11.05.pdf.

⁴⁶ Wisconsin Legislative Council, *supra* note 32, page 32.

The average worker in the U.S. today changes jobs about every four years, a phenomenon that has advantages and disadvantages but is an undeniable fact of contemporary life.

As the nation moved from agriculture to manufacturing, then to the service economy, and most recently to the so-called “digital economy,” people realized that the pace of change in technology and consumer demand made more-flexible workforces necessary and desirable. The average worker in the U.S. today changes jobs about every four years, a

phenomenon that has advantages and disadvantages but is an undeniable fact of contemporary life.

People who spend a short time working for the government have not earned a lifetime taxpayer subsidy. Even five years, the vesting term required by the majority of public pension systems, is too short in light of the need for workforce flexibility and the growing transferability of skills from public to private sectors.

According to the Wisconsin Legislative Council, “in 2008, a total of 64 plans, or 73.6% of the 87 plans in the report, require five or less years of service to vest.”⁴⁷ Switching to defined contribution plans properly makes the vesting issue irrelevant. Insofar as defined benefit plans remain, they should serve workers who give most of their careers to government service by being an option only for those who have worked for, say, 10 years or longer.

5. End Benefit “Spiking”

Probably the largest single source of abuse of public pensions is manipulation of the earnings basis for calculating pension benefits to dramatically increase or “spike” the cost of retirement benefits. Legislators in California have grappled with this problem probably as much as or more than any other state, and their limited success is a cautionary lesson for leaders who seek reform in this area.⁴⁸

Once again, switching to defined contribution plans would solve this problem. But where defined benefit plans remain, requiring that pension benefits be based on the average compensation of the last three years of employment, rather than the last year, is one important but only partial remedy. Double-dipping can be banned, penalized, or capped; benefits can be capped at no more than 75 percent of salary; health benefits can be limited and retiree contributions toward health insurance premiums required or increased.

⁴⁷ Ibid., p. 20.

⁴⁸ Ed Mendel, *supra* note 35.

6. Insist on Fund Solvency

Since defined benefit pensions by definition obligate taxpayers to make payments long after government officials leave office, they will always tempt elected officials and department heads to put short-term political and management objectives ahead of long-term solvency. This hazard will not be eliminated until and unless states move to defined contribution pensions. However, the temptation can at least be reined in by insisting that state legislatures fully fund their public pension funds.

Private companies, lacking the power to use forced taxation to fund their plans, had to choose between maintaining expensive pension systems or bankruptcy. In some instances, companies kept their pension plans and ended up in bankruptcy, forcing the end of their defined benefit pension plans.

The only good news is that the bill for years of under-funding public pensions has now come due, and every change to pension laws going forward must be evaluated in light of its impact on fund solvency.

San Diego has teetered on the brink of bankruptcy because of its defined benefit pension system, and in 2008 Vallejo, California, a San Francisco Bay-area city of about 120,000 persons, went into bankruptcy, largely because of its \$135 million unfunded pension liability. Even with the power of taxation, governments can go bankrupt.⁴⁹

Tax increases and borrowing are no guarantee of solvency. Illinois borrowed \$10.1 billion in pension obligation bonds in 2003 at 5.05 percent interest, and the pension situation has grown steadily worse. The only good news is that the bill for years of under-funding public pensions has now come due, and every change to pension laws going forward must be evaluated in light of its effect on fund solvency. Reforms that would have been considered too radical or politically impossible just two years ago must now be on the table, since nothing less than the bankruptcy of cities, public school districts, and even states is the only alternative.

6. Conclusion

Public-sector employee pensions have become too expensive, too cumbersome, and too burdensome for taxpayers. Massive unfunded liabilities are now devouring rapidly growing parts of state and local governments, causing spending to be cut on essential services. Current policies are financially unsustainable in many states.

Current pension policies are also unfair and cheat taxpayers. They deliver benefits that are much more generous than those of typical private-sector workers. They sometimes reward workers

⁴⁹ Steve Stanek, *supra* note 12.

who have worked for only brief times in the public sector, and who collect pensions from two, three, or even more positions. The benefits are often disproportionate to the sacrifices and investments that government workers make.

States can end the public pension crisis by putting government retirement benefits on par with those in the private sector.

A root cause of the public pension crisis is the decision made years ago to make defined benefit pension systems a standard perk for state and local government workers, and then to not move toward defined contribution plans as times changed and the rationale for defined benefit plans began to disappear. The

private sector made that transition, shifting more responsibility and risk onto employees for their retirement planning, and it has a more flexible workforce and lower long-term financial burdens as a result.

No two states have identical pension systems, but it is possible to compare and rank states according to several plan features that most affect the cost, fairness, and solvency of the plans. This report identifies six such features and ranks all 50 states according to how they compare with other states. Those factors are: (1) employee contribution, (2) choice of retirement plan, (3) taxable benefits, (4) time before vesting, (5) earnings basis for pensions, and (6) fund solvency.

Using these six variables, we identified the “worst” and “best” states, based on what would best serve the interests of taxpayers and the goal of state fiscal solvency. The five states with the highest-scoring public pension systems are Alaska, Florida, North Carolina, Washington, and North Dakota. The five states with the lowest-scoring public pension systems are Kansas, Louisiana, Hawaii, Illinois, and Oklahoma.

States can end the public pension crisis by putting government retirement benefits on par with those in the private sector. Specifically, we recommend making employees contribute more to their retirement, moving from defined benefit to defined contribution plans, making benefits taxable, increasing the number of years of service required before vesting and used to determine pension benefits, and making full funding of pension funds the highest objective of pension reform.

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Appendix

**Table 9.
State Pension Funds, Enrollment, and Enrollment
as Percent of Total State Enrollment**

| State | Fund Name | Enrollment | Total State Enrollment | Percent of Total State Enrollment |
|-------------|-----------|------------|------------------------|-----------------------------------|
| Alabama | TRS | 208,456 | 329,878 | 63.19% |
| Alabama | ERS | 121,422 | 329,878 | 36.81% |
| Alaska | PERS | 52,932 | 71,489 | 74.04% |
| Alaska | TRS | 18,557 | 71,489 | 25.96% |
| Arizona | SRS | 320,403 | 413,076 | 100.00% |
| Arkansas | TRS | 96,973 | 164,868 | 58.82% |
| Arkansas | PERS | 67,895 | 164,868 | 41.18% |
| California | TRS | 685,346 | 1,991,158 | 34.42% |
| California | PERS | 1,305,812 | 1,991,158 | 65.58% |
| Colorado | PERA | 271,332 | 352,297 | 100.00% |
| Connecticut | SERS | 91,289 | 171,814 | 53.13% |
| Connecticut | TRS | 80,525 | 171,814 | 46.87% |
| Delaware | SEPP | 52,820 | 70,876 | 100.00% |
| Florida | FRS | 959,554 | 1,235,806 | 100.00% |
| Georgia | TRS | 303,657 | 414,529 | 73.25% |
| Georgia | ERS | 110,872 | 414,529 | 26.75% |
| Hawaii | ERS | 100,575 | 135,899 | 100.00% |
| Idaho | PERS | 97,677 | 128,589 | 100.00% |
| Illinois | TRS | 257,034 | 654,831 | 39.25% |
| Illinois | SERS | 127,050 | 654,831 | 19.40% |
| Illinois | MRF | 270,747 | 654,831 | 41.35% |
| Indiana | PERF | 199,195 | 318,268 | 62.59% |
| Indiana | TRF | 119,073 | 318,268 | 37.41% |
| Iowa | PERS | 255,132 | 342,441 | 100.00% |
| Kansas | PERS | 217,992 | 282,180 | 100.00% |
| Kentucky | TRS | 116,278 | 344,862 | 33.72% |
| Kentucky | ERS | 90,189 | 344,862 | 26.15% |
| Kentucky | CERS | 138,395 | 344,862 | 40.13% |
| Louisiana | SERS | 99,355 | 250,164 | 39.72% |

| State | Fund Name | Enrollment | Total State Enrollment | Percent of Total State Enrollment |
|----------------|-----------|------------|------------------------|-----------------------------------|
| Louisiana | TRSL | 150,809 | 250,164 | 60.28% |
| Maine | PERS | 85,584 | 119,766 | 100.00% |
| Maryland | SRPS | 311,677 | 424,099 | 100.00% |
| Massachusetts | SERS | 137,402 | 277,062 | 49.59% |
| Massachusetts | TRS | 139,660 | 277,062 | 50.41% |
| Michigan | MERS | 61,130 | 583,683 | 10.47% |
| Michigan | PSERS | 445,907 | 583,683 | 76.40% |
| Michigan | SERS | 76,646 | 583,683 | 13.13% |
| Minnesota | MSRS | 73,707 | 405,497 | 18.18% |
| Minnesota | PERA | 207,662 | 405,497 | 51.21% |
| Minnesota | TRA | 124,128 | 405,497 | 30.61% |
| Mississippi | PERS | 239,273 | 312,813 | 100.00% |
| Missouri | PSRS | 120,174 | 249,628 | 48.14% |
| Missouri | SERS | 84,674 | 249,628 | 33.92% |
| Missouri | LAGERS | 44,780 | 249,628 | 17.94% |
| Montana | PERS | 44,920 | 75,000 | 59.89% |
| Montana | TRS | 30,080 | 75,000 | 40.11% |
| Nebraska | SEPP | 17,610 | 78,679 | 22.38% |
| Nebraska | CEPP | 7,898 | 78,679 | 10.04% |
| Nebraska | SPP | 53,171 | 78,679 | 67.58% |
| Nevada | PERS | 139,682 | 173,161 | 100.00% |
| New Hampshire | NHRS | 73,858 | 96,728 | 100.00% |
| New Jersey | TPAF | 211,366 | 663,565 | 31.85% |
| New Jersey | PERS | 452,199 | 663,565 | 68.15% |
| New Mexico | PERA | 77,417 | 172,307 | 44.93% |
| New Mexico | ERA | 94,890 | 172,307 | 55.07% |
| New York | TRS | 411,607 | 1,268,768 | 32.44% |
| New York | ERS | 857,161 | 1,268,768 | 67.56% |
| North Carolina | TSERS | 484,345 | 654,712 | 73.98% |
| North Carolina | LGERS | 170,367 | 654,712 | 26.02% |
| North Dakota | TRF | 15,878 | 42,010 | 37.80% |
| North Dakota | PERS | 26,132 | 42,010 | 62.20% |
| Ohio | STRS | 299,833 | 840,351 | 35.68% |
| Ohio | PERS | 540,518 | 840,351 | 64.32% |
| Oklahoma | TRS | 133,916 | 205,069 | 65.30% |

| State | Fund Name | Enrollment | Total State Enrollment | Percent of Total State Enrollment |
|----------------|-----------|------------|------------------------|-----------------------------------|
| Oklahoma | PERS | 71,153 | 205,069 | 34.70% |
| Oregon | PERS | 296,692 | 394,758 | 100.00% |
| Pennsylvania | SERS | 219,012 | 665,242 | 32.92% |
| Pennsylvania | PSERS | 446,230 | 665,242 | 67.08% |
| Rhode Island | ERS | 58,470 | 81,889 | 100.00% |
| South Carolina | SCRS | 288,865 | 389,762 | 100.00% |
| South Dakota | SRS | 57,028 | 76,349 | 100.00% |
| Tennessee | CRS | 310,955 | 409,185 | 100.00% |
| Texas | ERS | 207,304 | 1,418,569 | 14.61% |
| Texas | TRS | 1,076,683 | 1,418,569 | 75.90% |
| Texas | MRS | 134,582 | 1,418,569 | 9.49% |
| Utah | SRS | 125,307 | 157,038 | 100.00% |
| Vermont | SRS | 12,997 | 29,237 | 44.45% |
| Vermont | TRS | 16,240 | 29,237 | 55.55% |
| Virginia | SRS | 482,131 | 618,525 | 100.00% |
| Washington | TRS | 103,030 | 332,296 | 31.01% |
| Washington | PERS | 229,266 | 332,296 | 68.99% |
| West Virginia | PERS | 56,403 | 120,144 | 46.95% |
| West Virginia | TRS | 63,741 | 120,144 | 53.05% |
| Wisconsin | WRS | 407,219 | 551,252 | 100.00% |
| Wyoming | WRS | 51,296 | 67,571 | 100.00% |

Note: Almost all states in the study maintain smaller pension systems not evaluated in this study. Thus, 100% in column 5 means that particular plan enrolls 100% of the employees enrolled in a major public-sector pension plan in the state.

**Table 10.
Scores for State Pension Plans**

| State | Fund Name | Score | Contributions | Vesting | Earnings Basis | Taxable Benefits | Solvency | Choice of Plans |
|---------------|-----------|-------|---------------|---------|----------------|------------------|----------|-----------------|
| Alabama | TRS | -20 | -5 | 5 | -8 | -5 | -7 | 0 |
| Alabama | ERS | -15 | 0 | 5 | -8 | -5 | -7 | 0 |
| Alaska | PERS | 26 | 5 | 0 | 0 | 1 | 20 | 0 |
| Alaska | TRS | 26 | 5 | 0 | 0 | 1 | 20 | 0 |
| Arizona | SRS | -5 | 5 | -5 | -5 | 0 | 0 | 0 |
| Arkansas | TRS | -20 | -15 | 0 | -5 | 0 | 0 | 0 |
| Arkansas | PERS | -13 | -15 | 0 | -5 | 0 | 7 | 0 |
| California | TRS | -13 | -8 | 0 | -10 | 5 | 0 | 0 |
| California | PERS | 7 | 0 | 0 | -5 | 5 | 7 | 0 |
| Colorado | PERA | -23 | -5 | 0 | -5 | -3 | -15 | 5 |
| Connecticut | SERS | -30 | -15 | 0 | -5 | 5 | -15 | 0 |
| Connecticut | TRS | -5 | 5 | 5 | -5 | 5 | -15 | 0 |
| Delaware | SEPP | 12 | 0 | 0 | -5 | -3 | 20 | 0 |
| Florida | FRS | 24 | -10 | 3 | 5 | 1 | 20 | 5 |
| Georgia | TRS | -8 | -8 | 5 | -9 | -3 | 7 | 0 |
| Georgia | ERS | -15 | -15 | 5 | -9 | -3 | 7 | 0 |
| Hawaii | ERS | -25 | 0 | 0 | -5 | -5 | -15 | 0 |
| Idaho | PERS | -1 | -8 | 0 | -5 | 5 | 7 | 0 |
| Illinois | TRS | -42 | -15 | 3 | 0 | -5 | -25 | 0 |
| Illinois | SERS | -20 | 0 | 0 | 0 | -5 | -15 | 0 |
| Illinois | MRF | -10 | -8 | 3 | 0 | -5 | 0 | 0 |
| Indiana | PERF | 15 | -15 | 5 | 5 | 5 | 15 | 0 |
| Indiana | TRF | -18 | -8 | 5 | 5 | 5 | -25 | 0 |
| Iowa | PERS | -10 | -8 | -1 | -5 | -3 | 7 | 0 |
| Kansas | PERS | -28 | -8 | 5 | -5 | -5 | -15 | 0 |
| Kentucky | TRS | -23 | 0 | 0 | -5 | -3 | -15 | 0 |
| Kentucky | ERS | -8 | 5 | 0 | 5 | -3 | -15 | 0 |
| Kentucky | CERS | 0 | 5 | 0 | 5 | -3 | -7 | 0 |
| Louisiana | SERS | -33 | -8 | 0 | -5 | -5 | -15 | 0 |
| Louisiana | TRSL | -20 | 0 | 5 | -5 | -5 | -15 | 0 |
| Maine | PERS | -20 | -15 | 0 | -5 | 0 | 0 | 0 |
| Maryland | SRPS | -23 | -15 | 0 | -5 | -3 | 0 | 0 |
| Massachusetts | SERS | -7 | 5 | 5 | -5 | -5 | -7 | 0 |

| State | Fund Name | Score | Contributions | Vesting | Earnings Basis | Taxable Benefits | Solvency | Choice of Plans |
|----------------|-----------|-------|---------------|---------|----------------|------------------|----------|-----------------|
| Massachusetts | TRS | -7 | 5 | 5 | -5 | -5 | -7 | 0 |
| Michigan | MERS | -22 | -10 | 5 | -5 | -5 | -7 | 0 |
| Michigan | PSERS | -2 | 0 | 5 | 5 | -5 | -7 | 0 |
| Michigan | SERS | -20 | -8 | 5 | -5 | -5 | -7 | 0 |
| Minnesota | MSRS | 14 | 0 | -3 | 5 | 5 | 7 | 0 |
| Minnesota | PERA | 7 | 0 | -3 | 5 | 5 | 0 | 0 |
| Minnesota | TRA | 0 | 0 | -3 | 5 | 5 | -7 | 0 |
| Mississippi | PERS | -17 | -8 | 3 | 0 | -5 | -7 | 0 |
| Missouri | PSRS | -18 | -10 | 0 | -5 | -3 | 0 | 0 |
| Missouri | SERS | 17 | 0 | 0 | 5 | -3 | 15 | 0 |
| Missouri | LAGERS | -8 | 0 | 0 | -5 | -3 | 0 | 0 |
| Montana | PERS | 7 | 0 | 0 | -5 | 0 | 7 | 5 |
| Montana | TRS | -5 | 0 | 0 | -5 | 0 | 0 | 0 |
| Nebraska | SEPP | 12 | -5 | -3 | -5 | 5 | 20 | 0 |
| Nebraska | CEPP | 17 | -5 | -3 | 0 | 5 | 20 | 0 |
| Nebraska | SPP | 12 | 0 | 0 | 0 | 5 | 7 | 0 |
| Nevada | PERS | -11 | 0 | 0 | -5 | 1 | -7 | 0 |
| New Hampshire | NHRS | -20 | 0 | 5 | -5 | -5 | -15 | 0 |
| New Jersey | TPAF | -10 | 0 | 5 | -5 | -3 | -7 | 0 |
| New Jersey | PERS | -15 | -5 | 5 | -5 | -3 | -7 | 0 |
| New Mexico | PERA | 22 | 5 | 0 | 5 | 5 | 7 | 0 |
| New Mexico | ERA | -22 | -15 | 0 | -5 | 5 | -7 | 0 |
| New York | TRS | 2 | -8 | 0 | -5 | -5 | 20 | 0 |
| New York | ERS | -5 | -15 | 0 | -5 | -5 | 20 | 0 |
| North Carolina | TSERS | 25 | 5 | 0 | 0 | 0 | 20 | 0 |
| North Carolina | LGERS | 20 | 5 | 0 | 0 | 0 | 15 | 0 |
| North Dakota | TRF | 17 | 0 | 0 | 5 | 5 | 7 | 0 |
| North Dakota | PERS | 19 | 0 | -3 | -8 | 5 | 20 | 5 |
| Ohio | STRS | 0 | -5 | 0 | -5 | 5 | 0 | 5 |
| Ohio | PERS | 7 | -5 | 0 | -5 | 5 | 7 | 5 |
| Oklahoma | TRS | -25 | -15 | 3 | 5 | -3 | -15 | 0 |
| Oklahoma | PERS | -23 | -5 | 0 | -8 | -3 | -7 | 0 |
| Oregon | PERS | 15 | -5 | 0 | -5 | 5 | 20 | 0 |
| Pennsylvania | SERS | -11 | -8 | 0 | -5 | -5 | 7 | 0 |
| Pennsylvania | PSERS | 2 | 5 | 0 | -5 | -5 | 7 | 0 |

| State | Fund Name | Score | Contributions | Vesting | Earnings Basis | Taxable Benefits | Solvency | Choice of Plans |
|----------------|-----------|-------|---------------|---------|----------------|------------------|----------|-----------------|
| Rhode Island | ERS | -5 | 5 | 5 | -5 | 5 | -15 | 0 |
| South Carolina | SCRS | -23 | -5 | 0 | -5 | -3 | -15 | 5 |
| South Dakota | SRS | 5 | 0 | -3 | -8 | 1 | 15 | 0 |
| Tennessee | CRS | -3 | -10 | 0 | 5 | -5 | 7 | 0 |
| Texas | ERS | -11 | 0 | 0 | -5 | 1 | -7 | 0 |
| Texas | TRS | 13 | 0 | 0 | 5 | 1 | 7 | 0 |
| Texas | MRS | -7 | -8 | 0 | 0 | 1 | 0 | 0 |
| Utah | SRS | -19 | -10 | -1 | -5 | -3 | 0 | 0 |
| Vermont | SRS | 7 | 0 | 0 | -5 | 5 | 7 | 0 |
| Vermont | TRS | -5 | -5 | 0 | -5 | 5 | 0 | 0 |
| Virginia | SRS | -13 | -5 | 0 | -5 | -3 | 0 | 0 |
| Washington | TRS | 21 | -10 | 0 | 5 | 1 | 20 | 5 |
| Washington | PERS | 21 | -10 | 0 | 5 | 1 | 20 | 5 |
| West Virginia | PERS | -23 | -15 | 0 | -8 | 0 | 0 | 0 |
| West Virginia | TRS | -15 | -5 | 0 | 5 | 0 | -15 | 0 |
| Wisconsin | WRS | 5 | 0 | -5 | -5 | 0 | 15 | 0 |
| Wyoming | WRS | -12 | 0 | -1 | -5 | 1 | -7 | 0 |

About the Authors

Eli Lehrer is senior fellow at The Heartland Institute and national director of its Center on Finance, Insurance, and Real Estate.

Lehrer played a major role in founding the smartersafer.org coalition, a coalition of taxpayer, environmental, insurance, and free-market groups dedicated to risk-based insurance rates, mitigation, and environmental protection.

Prior to joining Heartland, Lehrer worked as speechwriter to United States Senate Majority Leader Bill Frist (R.-Tenn.). He has previously worked as a manager in the Unisys Corporation's Homeland Security Practice, senior editor of *The American Enterprise* magazine, and as a fellow for The Heritage Foundation. He has spoken at Yale and George Washington Universities.

Steve Stanek is a research fellow for The Heartland Institute and managing editor of *Budget & Tax News*. He has been a freelance writer and editor since 1997, producing marketing materials and business articles for corporate clients, as well as feature articles and news stories for Chicago-area newspapers, magazines, and business publications.

Before becoming a freelance writer, Stanek worked nearly 11 years in corporate communications. He also has worked as a newspaper reporter and editor at weekly and daily newspapers in Illinois.

About The Heartland Institute

The Heartland Institute is a national nonprofit organization based in Chicago. Founded in 1984, it began as a state-based free-market think tank but soon evolved into a regional and, since 1993, a national organization.

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Policy Documents

Research & Commentary: Public Pensions and the Assumed Rate of Return

Matthew Glans - July 23, 2012
Heartland Institute

In states and municipalities across the country, the high cost of traditional defined-benefit public pensions has become a hot-button issue as unfunded liabilities have raced out of control. These increasing liabilities are further complicated by the fact that in many instances the regulators controlling pension funds have overestimated the value of future investments and the rate of return they can expect from the investments held by the pension fund.

If the estimated rate of return for these pension funds continues to fall short of expectations, pension systems across the country may be in even more trouble than is currently thought. Fortunately, pension fund regulators and lawmakers are beginning to notice this problem and are moving to set more reasonable expectations for investment returns. According to the National Association of State Retirement Administrators, since 2008, 19 public pension plans have lowered the assumed rate of return below 8 percent, and others, including Minnesota and New York, are considering doing so.

Decreasing the expected rate of return does have consequences. Because the rate is used to determine the present value of benefits that will be paid to retired workers in the future, reducing the rate of return will increase the apparent level of obligations. Opponents of the decrease argue it is unnecessary because actual public pension investment returns have exceeded assumptions. Overly optimistic rates of returns, however, have significantly contributed to the recent unsustainability of these funds.

Proponents of a decrease argue that even if state and local pension funds continue the current high return rate assumptions, it will take large-scale increases to bring their funds into actuarial balance, which will prove difficult in the current economy. According to the American Legislative Exchange Council, "Even with a questionably high eight percent assumed rate of return on assets, government employers would have to significantly increase contribution rates to bring the plans into actuarial balance. This would be difficult given the current recession and associated revenue shortfall. The financial crisis encountered over the past decade reveals that many state pension plans are fundamentally flawed."

In the short term, per-year pension payouts should be capped at a sensible level, the retirement age should be raised, double-dipping should be eliminated, pension rate of return assumptions should be changed, and workers should be required to make higher contributions. In the long term, sustainability will require governments to follow the private sector's lead and switch workers from defined-benefit pension systems to defined-contribution systems.

The following articles examine state and local pension funds and the assumed rates of return from multiple perspectives.

Public Pensions Faulted for Bets on Rosy Returns

<http://www.nytimes.com/2012/05/28/nyregion/fragile-calculus-in-plans-to-fix-pension-systems.html?pagewanted=all>

Mary Williams Walsh and Danny Hakim report on the debate over public pension rates of return. They speak with several economists and pension experts on the issue and discuss current reform proposals in several states.

Mass. Needs More Realistic Goal for Pension Fund Returns

http://articles.boston.com/2012-06-24/editorials/32379572_1_pension-fund-public-pensions-pension-increases

In an editorial, the *Boston Globe* argues the State of Massachusetts needs to start stepping down its pension expectations. The editorial argues for a deliberate approach to limit the impact on government agencies whose employees will have to contribute more.

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Events

Upcoming

The State Public Pension Crisis: A 50-State Report Card

http://heartland.org/sites/all/modules/custom/heartland_migration/files/pdfs/27578.pdf

This Heartland Institute report examines problems currently facing public pension systems, including the enormous burdens public employee pensions pose in some locations. The report ranks each state according to the operation and relative disposition of the pension plans in the 50 states and suggests ways states might go about solving their pension system problems.

Are State Public Pensions Sustainable? Why the Federal Government Should Worry about State Pension Liabilities

<http://heartland.org/policy-documents/are-state-public-pensions-sustainable-why-federal-government-should-worry-about-sta>

Joshua D. Rauh of Northwestern University analyzes the flow of state pension benefit payments relative to asset levels and contributions. Even assuming future state contributions fund the full present value of new benefits, many state systems will run out of money in 10 to 20 years if some attempt is not made to improve the funding of liabilities that already have accrued. The expected shortfalls raise the possibility that the federal government will be faced with a decision on whether to bail out states driven to insolvency by their pension programs.

Public Pension Plan Asset Allocations

<http://heartland.org/policy-documents/public-pension-plan-asset-allocations>

Youngkyun Park of the Employee Benefit Research Institute reviews public pension plan contribution behavior from 2001 to 2006, pension asset allocations from 2003 to 2007, and the effect investment performance has on employer contribution volatility. Park concludes that in the short run a significant shift toward a lower-return investment policy in exchange for reduced volatility in employer contributions is unlikely to occur because of plans sponsors' expected high returns from current asset allocations based upon historical rates of return, their ability to use the assumed investment rate of return as the discount rate in calculating liabilities, and the understandable tendency of investment managers not to deviate from peer group investments.

Unmasking Hidden Costs: Best Practices for Public Pension Transparency

http://www.manhattan-institute.org/html/cr_63.htm

In this *Civic Report* from the Manhattan Institute for Policy Research, Josh Barro makes several recommendations for improving the transparency of financial information related to governments' pension and OPEB obligations.

Pensions Wrestle with Return Rates

<http://online.wsj.com/article/SB10001424052970204450804576620951874861390.html>

Michael Corkery reports in the *Wall Street Journal* on the efforts by lawmakers and pension officials to reduce the roughly 8 percent annual-return assumption set by many public-employee funds, as they argue the rate is unrealistically high given the financial crisis and upheavals in markets around the world.

State Pension Funds Fall Off a Cliff

<http://heartland.org/policy-documents/state-pension-funds-fall-cliff>

Barry W. Poulson and Arthur P. Hall consider different measures of historical and current funding shortfalls in state pension plans. Two case studies are examined in depth to explore fatal flaws that have caused funding crises in these plans: the Public Employee Retirement Association of Colorado (PERA) and the Kansas Public Employee Retirement System (KPERs).

The Market Value of Public-Sector Pension Deficits

<http://heartland.org/policy-documents/market-value-public-sector-pension-deficits>

Arthur Biggs of the American Enterprise Institute argues that because states currently assume plans can earn high returns without risk, they are underfunded by more than \$3 trillion. Although states recognize their public-employee pensions are underfunded, Biggs argues the situation is far worse than their accounting demonstrates. Unless policymakers take proactive steps now, he says, taxpayers will have to cover an enormous shortfall when the bills come due.

The Origins and Severity of the Public Pension Crisis

<http://heartland.org/policy-documents/origins-and-severity-public-pension-crisis>

Dean Baker of the Center for Economic and Policy examines the origins of the shortfalls in public pension systems and discusses the appropriate rate of return to assume for pension fund assets.

Nothing in this Research & Commentary is intended to influence the passage of legislation, and it does not necessarily represent the views of The Heartland Institute. For further information on this and other topics, visit the FIRE Policy News Web site at <http://news.heartland.org/insurance-and-finance>, The Heartland Institute's Web site at www.heartland.org, and PolicyBot, Heartland's free online research database, at www.policybot.org.

If you have any questions about this issue or The Heartland Institute, contact Heartland Institute Senior Policy Analyst Matthew Glans at 312/377-4000 or mglans@heartland.org.

Mallory Factor Shadowbosses:

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2013 Emerging Issues Forum - Atlanta

Capital City Club, 7 John Portman Boulevard, Atlanta, GA 30303

August 15, 2013, 8:30 AM

David B. Kopel - The Truth About Gun Control

The Heartland Institute, One South Wacker Drive, Suite 2740, Chicago, IL 60606

September 05, 2013, 11:30 AM

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Policy Documents

Research & Commentary: Kentucky Pension Reform

Matthew Glans – March 2, 2013

Heartland Institute

Kentucky's government employee pension system is currently carrying a \$33 billion unfunded liability and has less than half the money it needs to cover all its present and future obligations. Both houses of the Kentucky General Assembly are considering proposals that would reform the state's failing pension system.

One proposal would [create a new 401\(k\)-style hybrid plan](#) for new state employees and eliminate annual cost-of-living increases for retirees. This legislation, Senate Bill 2, is based on recommendations from a legislative task force that reviewed Kentucky's financially troubled pension system.

The legislation also recommends the state pay its full contribution to the Kentucky Retirement Systems beginning next fiscal year, meaning an additional \$200 million in funds for the pension system. The bill does not include a new funding source for payments.

When SB 2 reached the Kentucky House of Representatives, lawmakers struck language from the bill that shifted the system for new workers to a 401(k)-like plan, and they added new language allowing retirees to receive cost-of-living increases as long as the state can afford them. Proposals for [new revenue sources for the state's pension system](#) include increasing the state's cigarette tax from 60 cents to \$1 per pack and new revenue from lottery games and horse tracks.

Raising taxes and ignoring the core problems created by the state's current defined benefit system only ensure that Kentucky's pension system will never become solvent. Comprehensive reforms that allow the state to better manage employee retirement costs are desperately needed.

By placing newly hired public-sector workers in a defined-contribution pension plan, the state would be able to reduce the cost of retirement benefits and prevent new unfunded pension liabilities. State workers would gain flexibility with their retirement benefits because they would own their pensions and be able to keep them if they leave the public sector.

The documents linked below offer additional information about pension system reform in Kentucky and elsewhere.

Kentucky Pension Reform Bill Clears First Hurdle

<http://www.kentucky.com/2013/02/06/2505458/kentucky-pension-reform-bill-clears.html>

Beth Musgrave of the *Lexington Herald-Leader* examines the pension reform bill proposed in the Kentucky Senate that would move new state employees to a 401(k)-style hybrid plan and eliminate annual cost-of-living increases for retirees.

House Passes Pension Bills, Sends Them to Senate

<http://www.kentucky.com/2013/02/27/2534683/house-passes-pension-bills-sends.html>

Roger Alford of the Associated Press examines the Kentucky House's changes to and passage of the Senate's pension reform bill and the passage of additional legislation for new revenue to fund the state pension program. "Revenue from lottery games and slot-like machines at horse tracks could be used to shore up Kentucky's pension plans for government retirees under legislation that passed the Democratic-controlled House largely along party lines," he writes.

Kentucky's Pension Challenges: Opportunities for Real Reform

<http://heartland.org/policy-documents/kentuckys-pension-challenges-opportunities-real-reform>

This paper from the Pew Center on the States examines the challenges posed by Kentucky's failing pension system, how those problems came to happen, and some opportunities for reform.

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Future Shock: Kentucky Politicians' Opulent Pensions Have Become a Modern Day Gold Rush

<http://heartland.org/policy-documents/future-shock-kentucky-politicians-opulent-pensions-have-become-modern-day-gold-rush>

Lowell Reese, owner of Kentucky Roll Call, a public affairs publishing company in Frankfort, and a former state chamber of commerce executive, names both current and previous legislators who personally benefited from critical votes approving House Bill 299 in 2005.

Future Shock: Legislators Stoking the Coals on Kentucky's Runaway Pension Train

<http://heartland.org/policy-documents/future-shock-legislators-stoking-coals-kentucky-runaway-pension-train>

The second of the [Bluegrass Institute's](#) four-part "Future Shock" series written by Lowell Reese chronicles the disintegration of the commonwealth's six retirement systems and urges lawmakers to undo the bad decisions that brought about the problems.

Research & Commentary: Defined Contribution vs. Defined Benefit Pensions

<http://heartland.org/policy-documents/defined-contribution-vs-defined-benefit-pensions>

John Nothdurft of The Heartland Institute provides a bullet-point comparison of defined-benefit pensions and defined-contribution retirement plans.

The Gathering Pension Storm: How Government Pension Plans Are Breaking the Bank and Strategies for Reform

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The Reason Foundation tackles the looming crisis created by states' continued use of defined-benefit pension plans, offering solutions to the problem and an analysis of why the current system is a disaster in the making.

The State Public Pension Crisis: A 50-State Report Card

<http://heartland.org/policy-documents/no-126-state-public-pension-crisis-50-state-report-card>

The Heartland Institute examines problems facing public pension systems, including the enormous burdens they pose in some locations. The report ranks each state on the operation and disposition of its pension plans and suggests ways to solve states' pension system problems.

Research & Commentary: Public Pensions and the Assumed Rate of Return

<http://heartland.org/policy-documents/research-commentary-public-pensions-and-assumed-rate-return>

Heartland Institute Senior Policy Analyst Matthew Glans examines the problems facing state and local pension funds, how assumed rates of return affect pension fund debt, and proposals to change the projected rates of return on pension fund investments.

Are State Public Pensions Sustainable? Why the Federal Government Should Worry about State Pension Liabilities

<http://heartland.org/policy-documents/are-state-public-pensions-sustainable-why-federal-government-should-worry-about-sta>

Joshua D. Rauh of Northwestern University analyzes the flow of state pension benefit payments relative to asset levels and contributions. Even assuming future state contributions fund the full present value of new benefits, many state systems will run out of money in 10 to 20 years unless they improve the funding of liabilities already accrued. The expected shortfalls raise the possibility the federal government will be asked to bail out states driven to insolvency by their pension programs.

State Pension Funds Fall Off a Cliff

<http://heartland.org/policy-documents/state-pension-funds-fall-cliff>

Barry W. Poulson and Arthur P. Hall consider different measures of historical and current funding shortfalls in state pension plans. Two case studies—the Public Employee Retirement Association of Colorado (PERA) and the Kansas Public Employee Retirement System (KPERs)—are examined in depth to explore the fatal flaws that have caused funding crises in these plans.

Let Employees Control Future of Retirements

https://www.cato.org/pub_display.php?pub_id=6556

Jagadeesh Gokhale and Peter Van Doren of the Cato Institute explain why the market is best-suited to relieve the fiscal pressures caused by state pension funds.

Nothing in this *Research & Commentary* is intended to influence the passage of legislation, and it does not necessarily represent the views of The Heartland Institute. For further information on this and other topics, visit the FIRE Policy News Web site at <http://news.heartland.org/insurance-and-finance>, The Heartland Institute's Web site at www.heartland.org, and PolicyBot, Heartland's free online research database, at www.policybot.org.

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One South Wacker Drive #2740
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Phone: 312/377-4000
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Policy Documents

Research & Commentary: Illinois Pension Reform

Matthew Glans – March 28, 2013

Heartland Institute

The state employee pension system in Illinois is broke, both financially and structurally. Without an overhaul of the current, unsustainable system, Illinois taxpayers will continue to suffer substantially higher taxes to bail out the state for its imprudent policies. If state workers and union representatives cannot accept sensible changes to the pension system, more state workers will be laid off, taxes will increase, and the state's economy will decline even further.

A bill currently being considered would take bold steps toward creating a pension fund that allows the state to ensure its obligations to workers while keeping costs down. Based on a [model from the Illinois Policy Institute, House Bill 3303](#), sponsored by Reps. Tom Morrison (R-Palatine) and Jeanne Ives (R-Wheaton), would cut the state's unfunded pension debt in half, move new hires into a 401(k)-style defined contribution plan, and protect the benefits that government workers already have earned.

The bill would end the pension payment ramp and freeze cost-of-living increases until the fund's fiscal health improves. It also would set the retirement age for state workers at the same level as Social Security and would increase the responsibility of local governments for their pension plans by requiring them to pay the employer's share of their workers' retirement savings plans.

In a statement, Morrison argued workers need additional control over their retirement funds in order to maintain pension benefits in the long run. Under a defined-contribution plan, employers pay a fixed amount during the course of a worker's career. That amount is deposited into a personal account the worker controls and manages. This allows workers to customize their retirement funds to fit their own needs.

According to its sponsors, the Morrison-Ives bill would reduce the unfunded pension liability by 46 percent in fiscal year 2014, a total decrease of \$46 billion. In addition, the reforms would reduce yearly contributions to the fund in 2014 by 30 percent to \$4.7 billion, a sharp drop from the current \$6.7 billion annual payment. The proposal would eliminate the unfunded liability by 2045.

This proposal makes substantive reforms that cut current costs, manage future pension liabilities, and protect existing benefits for public employees. Defined-contribution plans, which are used extensively in the private sector, would allow the state to lower its pension costs while giving employees control over their retirement plans.

The documents linked below offer additional information about pension system reform.

Budget Solutions 2014: Pension Reform and Responsible Spending for State and Local Governments

<http://heartland.org/policy-documents/budget-solutions-2014-pension-reform-and-responsible-spending-state-and-local-gover>

Illinois has the worst-funded pension systems in the nation. The total unfunded liability currently stands at more than \$96 billion according to official government numbers, and that number grows by \$21 million every day lawmakers fail to enact reform. The Illinois Policy Institute plan would modernize the state's retirement system by giving government workers the secure retirement they deserve. Ultimately, these reforms restore fiscal order to the state by eliminating unsustainable pensions and unfunded liabilities. This paves the way for the economy to flourish, fostering an environment where businesses can thrive and create the jobs Illinoisans need.

401(k) Proposed for State Teachers

<http://daily-journal.com/archives/dj/display.php?id=504317>

Scott Reeder of the Illinois Policy Institute examines the key points of the institute's plan and the differences between its proposal and others being circulated in Springfield.

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Rep. Morrison on Plan to Fix Illinois Pension Crisis

<http://video.foxbusiness.com/v/2212297056001/rep-morrison-on-plan-to-fix-illinois-pension-crisis/>

Rep. Tom Morrison explains his pension reform proposal on the Fox Business Channel.

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http://heartland.org/sites/all/modules/custom/heartland_migration/files/pdfs/27578.pdf

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Pension Time Bomb

<http://www.washingtonpost.com/wp-dyn/content/article/2008/09/10/AR2008091002726.html>

Columnist George Will describes how a California city had to file for bankruptcy because of its underfunded and over-generous defined-benefit pension plan.

Defined Contribution Pension Plans in the Public Sector: A Best Practice Benchmark Analysis

<http://heartland.org/policy-documents/defined-contribution-pension-plans-public-sector-best-practice-benchmark-analysis>

The TIAA-CREF Institute "addresses best practice benchmarks for the design of public sector primary (core) defined contribution pension plans. [The white paper] includes an examination of the environmental conditions and factors affecting these plans as well as general principles for the design of effective defined contribution plans. Selected public sector core defined contribution plans are reviewed against identified best practices."

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