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Solutions to New Hampshire's Public Pension Crisis

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In the first installment of this series, "New Hampshire's Growing Public Retiree Funding Crisis," NHCEP used new academic research to show that, for FY 2008, New Hampshire's official unfunded pension liability of $2.5 billion was actually closer to $8.9 billion - an increase of 256 percent.[1] This same methodology shows that the FY 2010 official unfunded pension liability of $3.7 billion is more like $13.3 billion. Unless significant, serious and far-reaching changes are made soon, the pension system will run out of assets by 2022.

To put the size of this unfunded pension liability into perspective, every dollar of state and local taxes collected for over 2.5 years would be needed to close the $13.3 billion gap.[2] Clearly, this is unaffordable. Only by reforming the pension system will ensure a sustainable path for both government retirees and taxpayers. This study highlights some of these needed reforms.

Step 1 - Amend the State Constitution to Define and Control the Retiree Benefits System

In 1995, Maine enacted a Constitutional Amendment (see Appendix) to fully fund their public pension system. The Amendment accomplished three important goals:

1. Ensured that pension assets could only be used to fund pension benefits and could not be diverted to other purposes.
2. All future benefit increases had to be fully funded and could not added to the unfunded pension liability. Also, any investment losses (the only legal source of temporary underfunding of the system) had to paid within 10 years.
3. The unfunded pension liability had to be eliminated within 31 years starting in FY 1997 (or by FY 2028).

A similar Amendment in New Hampshire should be enacted but with two key changes: First, it should require conformity to the private sector accounting standards set by the Financial Accounting Standards Board (FASB) rather than Government Accounting Standards Board (GASB). Secondly, annual pension costs should be projected over the entire 30-year time period. Overall, this would achieve

1. *Transparency:* The inflated discount rate currently used under GASB would be lower under FASB providing a truer picture of the pension liability burden. GASB also allows for a payoff schedule of the unfunded pension liability based on a rolling 30-year basis. This is the equivalent of a homeowner refinancing their 30-year mortgage every year - in which case they would never actually pay off their mortgage. The Amendment would end this practice by setting a hard pay-off schedule over 30 years and corresponding projections of annual pension contributions.

2. *Accountability:* Thanks to the 30-year, rolling amortization period, it is too easy for politicians to increase government benefits without the need to immediately pay for them - the classic *"kicking the can down the road."* The Amendment would end this practice by requiring any future benefit increases in the defined-benefit system to be fully funded up-front.

3. *Stability:* Current government employees and retirees will be assured that their pensions earned to-date are safe, while taxpayers will be assured that costs will no longer spiral out-of-control.

Path to Pension Reform

Step 1 - Amend State Constitution to Define and Control the Retiree Benefits System

Step 2 - Move to a Defined-Contribution System for New and Non-Vested Employees

Step 3 - Enact Right-to-Work

Step 4 - Increase Pension Contributions

Step 5 - Ensure that the Government Workforce is Right-Sized

Step 6 - Do Not Raise Taxes

Step 2 - Move to a Defined-Contribution System for New and Non-Vested Employees

Due to the extent of the unfunded pension liabilities in the defined-benefit pension systems across the country, more and more states have been moving towards a defined-contribution system - similar to the 401k system that is popular in the private sector. New Hampshire should join this growing wave in order to reduce the long-term costs of the pension system. Currently, ten states and Washington, D.C. have moved to defined-contributions in one of three ways with varying levels of cost savings.[3]

First, the largest cost savings can be achieved by moving all new government employees into a defined contribution system. Currently, two states (Michigan in 1997 and Alaska in 2006) and the District of Columbia fall into this category

Second, the next largest cost savings can be achieved by having both a defined benefit and defined contribution system. Currently, two states (Indiana and Oregon) fall into this category.

Finally, many states allow for their employees to choose between a defined-benefit plan or a defined-contribution plan. However, depending on the specifics of each plan, there could be a lot of choice (both plans yielding very similar benefits) or very little choice (one plan yielding substantially greater benefits). As such, choice and, correspondingly, cost savings can vary by state. Currently, seven states (Washington, North Dakota, Montana, Florida, South Carolina, Ohio and Colorado) fall into this category. Utah recently enacted legislation in 2010 putting them into this category, but it does not become effective until July 1, 2011 so was excluded from the total count.[4]

Clearly, New Hampshire should enact the most effective option which means following in the footsteps of Michigan, Alaska and the District of Columbia, and move away from the current defined-benefit plan in the long-term by instituting a defined-contribution plan for new and non-vested employees.

However, police and firefighters pose a unique challenge in this transition to a defined-contribution system because they are not eligible to receive Social Security, which is an important fall-back option other government workers have. As such, a hybrid plan needs to be created that either a) moves police and firefighters into Social Security combined with a defined-contribution plan or b) allows police and firefighter to continue to participate in a modified defined-benefit system (see Step 4), as a replacement to Social Security, combined with a defined-contribution system. The option with the lower cost should be pursued.

Step 3 - Enact Right-to-Work

Enacting right-to-work, such as the current House Bill 474, provides needed flexibility for policymakers to manage their workforce.[5] Josh Barro, the Walter B. Wrinston Fellow at the Manhattan Institute, recently found that:

> "Not having to bargain employee contracts makes it easier for elected officials to control employment costs . . . [for example] the different budget environments in Fairfax County, Virginia, which does not use collective bargaining, and Montgomery County, Maryland, which does . . . Fairfax and Montgomery Counties are socio-economically and geographically similar, and both have been under Democratic leadership for years. But because Fairfax Democrats are empowered to enforce cost discipline as necessary, that county entered 2010 with only one-quarter the budget gap that Montgomery had, and with more tools at its disposal to close it."[6]

Additionally, right-to-work would significantly boost New Hampshire's long-term economic growth which would better equip the state to pay the pension burden. Richard Vedder, the Edwin and Ruth Kennedy Distinguished Professor of Economics at Ohio University, in the CATO Journal describes the national movement of people and economic growth toward right-to-work states. He concludes:

> "The proportion of Americans living in right-to-work states has risen noticeably over the years, and only a small part of that is driven by new states adopting such laws. People move in extraordinary numbers to right-to-work states from states where union pressure has prevented the adoption of such laws. Moreover, the greater flexibility for workers and employers offered where right-to-work exists has contributed to higher rates of economic growth rates in the right-to-work environment. Although the United States seems to have been in roughly a stable political equilibrium regarding these laws in recent decades, if the past trends toward the right-to-work population growing in a relative sense persists while union membership continues to fall as a proportion of the labor force, a threshold point should be passed where the political equilibrium should tip toward making right-to-work laws universal for the entire American population."[7]

Step 4 - Increase Pension Contributions

Moving to a defined-contribution plan will not reduce the pension liabilities associated with the defined-benefits system in place for the existing workforce. Yet, the reality is that these large unfunded pension liabilities will require reforming the level of future pension benefits. In their most recent study, Robert Novy-Marx (University of Chicago) and Joshua Rauh (Northwestern University) examine various policy options that can be used to reform the pension system.[8]

While they discuss a number of options, there are really only two that could be used to achieve significant restructuring of pension liabilities. First, eliminating all cost-of-living adjustments would save approximately 22 percent of current pension liabilities (or approximately $4 billion). Second, they estimate savings under "social security parameters" (increasing the full retirement age to 67 years, increasing the early retirement age to 65 years and implementing early retirement age buyouts) would save approximately another 22 percent (or approximately $4 billion).[9]

To witness the savings of these reforms, variations were included in Gov. LePage's budget proposal in Maine, and are estimated to reduce the state's official unfunded pension liability by $2.34 billion; from $4.4 billion to $2.06 billion.[10] The plan freezes pensions for three years, caps cost-of-living adjustments at 2 percent and creates parity with Social Security for new and recent hires (current retirement age of 66, then to 67 in 2027).

In this current legislative session, Senate Bill 3 deals with many of the issues raised by Novy-Marx and Rauh and would also be a good first step toward checking off Step 3.[11]

Step 5 - Ensure that the Government Workforce is Right-Sized

According to the U.S. Department of Commerce's Bureau of Economic Analysis, the average state and local government worker made $52,181 in 2009. However, each government position also represents a portion of the total pension liability which could increase the cost per employee by as much as $221,281.[12]

Therefore, it is imperative that the government workforce be "right-sized" in order to minimize the burden on taxpayers, especially for state government jobs since they earn, on average, more than local government jobs ($53,932 versus $51,441, respectively). For instance, Gov. Lynch's budget proposal to eliminate 1,100 positions would save, on average, over $300 million in reduced payroll ($60 million) and reduced total pension liabilities ($243 million).[13]

Additionally, any payroll reductions are an annual savings which could, wholly or partially, be used to increase the assets of the pension system by funding increased contributions.

Step 6 - Do Not Raise Taxes

Recent economic studies, at the international, national and state level, strongly suggest that reducing government spending is the better option, relative to increases in taxes, when deciding the best path to funding state pension obligations.

First, Harvard economists Alberto Alesina and Silvia Ardagna examine the economic effects of fiscal policy in countries that constitute the Organization for Economic Cooperation and Development from 1970 to 2007. They find that:

> "[a]s for fiscal adjustments those based upon spending cuts and no tax increases are more likely to reduce deficits and debt over GDP ratios than those based on tax increases. In addition, adjustments on the spending side rather than on the tax side are less likely to create recessions."[14]

Second, UC Berkeley economist David Romer and Christina Romer (former Chair of the Council of Economic Advisors to President Obama), examine the economic effects of U.S. fiscal policy since 1947. They find that:

> "The resulting estimates indicate that tax increases are highly contractionary. The effects are strongly significant, highly robust, and much larger than those obtained using broader measures of tax changes. The large effect stems in considerable part from a powerful negative effect of tax increase on investment."[15]

Finally, two economists at the Federal Reserve of Dallas Stephen Brown and Lori Taylor, along with Kathy Hayes (Southern Methodist University), examine the economic effects of fiscal policy of U.S. states. They find that:

> "If anything, most public services do not appear to justify the taxes needed to finance them . . . this finding would seem to imply that other state and local public capital has been increased to the point of negative returns, perhaps because a growing stock of other public capital is indicative of an increasingly intrusive government."[16]

Conclusion

New Hampshire state employees deserve their pay and are entitled to their benefits. In the same way, New Hampshire taxpayers deserve sound stewardship of their tax dollars, and are entitled to a transparent accounting of state expenditures - which includes the elimination of off-the-books promises that are passed on to future taxpayers as “unfunded liabilities.” The Six Steps outlined in this document suggest proven methods of correcting the long-term problems in the state pension system, and develop a fully funded state employee retirement system.

Appendix: Maine’s Constitutional Pension Amendment

> **Section 18. Limitation on use of funds of Maine State Retirement System.** All of the assets, and proceeds or income therefrom, of the Maine State Retirement System or any successor system and all contributions and payments made to the system to provide for retirement and related benefits shall be held, invested or disbursed as in trust for the exclusive purpose of providing for such benefits and shall not be encumbered for, or diverted to, other purposes. Funds appropriated by the Legislature for the Maine State Retirement System are assets of the system and may not be diverted or deappropriated by any subsequent action.
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> **Section 18-A. Funding of retirement benefits under the Maine State Retirement System.** Beginning with the fiscal year starting July 1, 1997, the normal cost of all retirement and ancillary benefits provided to participants under the Maine State Retirement System must be funded annually on an actuarially sound basis. Unfunded liabilities may not be created except those resulting from experience losses. Unfunded liability resulting from experience losses must be retired over a period not exceeding 10 years.
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> **Section 18-B. Payment of unfunded liabilities of the Maine State Retirement System.** Each fiscal year beginning with the fiscal year starting July 1, 1997, the Legislature shall appropriate funds that will retire in 31 years or less the unfunded liabilities of the Maine State Retirement System that are attributable to state employees and teachers. The unfunded liabilities referred to in this section are those determined by the Maine State Retirement System's actuaries and certified by the Board of Trustees of the Maine State Retirement System as of June 30, 1996.

Notes and Sources:

[1] Moody, J. Scott and Warcholik, Wendy P., “New Hampshire’s Growing Public Retiree Funding Crisis,” The New Hampshire Center for Economic Policy, Vol.1, Issue 1, February 17, 2011. http://nheconomics.org/wp-content/uploads/2010/08/NHCEP-Liberty-in-Economics-Volume-1-Issue-1-New-Hampshire-Pension-Crisis-021711.pdf

[2] The most recent tax data is from the U.S. Department of Commerce’s Census Bureau as of FY 2008.

[3] Golub-Sass, Alex, Haverstick, Kelly, Munnell, Alicia H., Soto, Mauricio, Wiles, Gregory, “Why Have Some States Introduced Defined Contribution Plans?” Center for Retirement Research, Boston College, Number 3, January 2008. http://crr.bc.edu/images/stories/Briefs/slp_3b.pdf?phpMyAdmin=43ac483c4de9t51d9eb41

[4] Snell, Ronald, “State Defined Contribution and Hybrid Pension Plans,” National Conference of State Legislatures, June 2010. http://www.ncsl.org/LinkClick.aspx?fileticket=yGsmFhwoq7E%3D&tabid=18511

[5] For full text of House Bill 474, see: http://www.gencourt.state.nh.us/legislation/2011/HB0474.html

[6] Barro, Josh, “Tools for Better Budgets: Options for State and Local Governments to Manage Employee Costs,” Manhattan Institute for Policy Research, Issue Brief, No. 9, March 2011, pg. 6. http://www.manhattan-institute.org/pdf/ib_09.pdf

[7] Vedder, Richard, “Right-to-Work Laws: Liberty, Prosperity, and Quality of Life,” CATO Journal, Vol. 30, No. 1, Winter 2010, pg. 180. http://www.cato.org/pubs/journal/cj30n1/cj30n1-9.pdf

[8] Novy-Marx, Robert and Rauh, Joshua D., “Policy Options for State Pensions Systems and Their Impact on Plan Liabilities,” prepared for the NBER State and Local Pensions Conference in Jackson Hole, Wyoming, August 2010. http://kelloggfinance.files.wordpress.com/2010/07/nmr_posps_20100718.pdf

[9] Note that these cost savings were derived as stand-alone estimates. As such, other reforms, such as moving to a defined-contribution system, prior to implementing these suggestions would likely change these savings estimates. The savings are also based on their “maximum pension” amount—see Table 4 in note 1.

[10] For more information on Gov. Lepage's pension reforms, see: http://www.maine.gov/budget/budgetinfo/2012-2013/Unfunded%20Liabilities%20Reform.pdf

[11] For full text of Senate Bill 3, see: http://www.gencourt.state.nh.us/legislation/2011/SB0003.html

[12] The $221,281 was derived by dividing the 2008 maximum pension liability (see note 1) scaled-up to a 2010 estimate (18.6 billion) by the total number of state and local government workers (83,845 as of 2009 using data from the U.S. Department of Commerce's Bureau of Economic Analysis).

[13] For more on Gov. Lynch's plan to cut payrolls, see: Schoenberg, Shira, "255 Layoffs Included in Lynch Budget," The Concord Monitor, February 15, 2011. http://www.concordmonitor.com/article/240340/255-layoffs-included-in-lynch-budget

[14] Alesina, Alberto and Ardagna, Silvia, "Large Changes in Fiscal Policy: Taxes versus Spending," NBER Working Paper No. 15438, October 2009. An earlier version of the study can be found here: http://www.economics.harvard.edu/faculty/alesina/files/Large%2Bchanges%2Bin%2Bfiscal%2Bpolicy_October_2009.pdf

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