Response to Ohio Public Employees Retirement System Regarding Hanging By a Thread

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Following the recent release of our report, **Hanging By a Thread: Big Payouts and Promises Leave Ohio Pension Plans on the Brink of Collapse—or a Massive Bailout,** representatives of the Ohio Public Employees Retirement System (OPERS) challenged several of the report's assertions. Since the Buckeye Institute values constructive dialogue regarding meaningful public pension reform that strengthens our state, we wish to address several of the issues raised within our report.[1]

First, OPERS claims that the average annual pension paid to all OPERS retirees is only $22,078. We do not dispute this and we acknowledge that fact on page eight of our report. But we also believe that this is a dramatic distortion of the true fiscal reality.

As we have argued in the past, the $22,078 figure is highly deceiving in that it includes disability and survivor claimants, as well as retirees with as little as five years of experience. According to page 134 of OPERS's latest Comprehensive Annual Financial Report (CAFR), there were 23,041 individuals receiving a pension due to disability and 13,437 pensioners listed as survivors. As to be expected, the pensions paid to these two groups of claimants are frequently smaller than the average pension paid out to a career employee.

Combined with survivors and disability claimants are those retirees with as little as five years of experience. The average annual pension for retirees with 5-10 years of experience is only $8,208. Many of these individuals possess outside sources of retirement income, either Social Security, 401(k)s, or personal savings acquired through private-sector employment.

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[1] We politely would remind the government pensions that the last time one of those entities claimed our work was erroneous, faulty, or misleading, that entity and its leader had to release the actual data that confirmed the accuracy of our work. See Matt A. Mayer and Mary McCleary, "A Final Word on the DROP Program and Our Report," November 12, 2010, at http://www.buckeyeinstitute.org/uploads/files/DROP%20-%20A%20Final%20Word(1).pdf (December 15, 2011).

The $22,078 figure that OPERS so frequently cites is so heavily skewed downward by the groups mentioned above that it is relatively worthless when attempting to objectively examine benefit levels. A far more useful figure, we argue, is the level of pension benefits that the system provides over the course of a full-length 30-year career. It provides a much better "apples-to-apples" comparison against the benefit levels that private-sector Ohioans receive. Therefore, our figure of $39,780 as the average yearly pension for a career government employee, as cited on page 137 of OPERS's 2010 CAFR, is far more accurate and honest.

Secondly, OPERS also makes the argument that since a vast majority (nearly 95 percent) of its members enroll in the defined-benefit plan, it is therefore a superior retirement vehicle compared to a defined-contribution system. We believe that this only confirms the obvious: Government workers, like any other person when faced with a choice, prefer the more generous and less risky option.

It is only rational for individuals to legally utilize their retirement system for maximum financial gain for themselves and for their families. Under the current system, the defined-benefit option is by far the best way for public employees to receive a generous, guaranteed retirement while facing zero risk. But employee choice clearly does not demonstrate which system is better for Ohio's fiscal health and its taxpayers; rather, it only highlights the overly generous nature of the defined-benefit system.

Thirdly, OPERS continues to claim that defined-benefit systems are a more cost-effective form of retirement. Their argument doesn't hold water. OPERS maintains that a transition to a defined-contribution system would be costly, and they are correct in a sense. Ohio's defined-benefit plans have left a $66 billion hole that would still need to be filled during any transition process. The irony in OPERS's argument though is that we supposedly cannot transition away from a defined-benefit system because it would force us to account for the unfunded liabilities that the defined-benefit plan created in the first place. Defined-contribution plans are not more expensive; they only force us to face the fiscal reality at hand.[2]

OPERS also has criticized defined-contribution plans for failing to provide adequate income for retirees. The main "problem" of defined-contribution plans has been that workers have not used them to the fullest extent possible, thereby leaving

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[2] Another element the government pensions cite is the higher administrative costs associated with private sector defined-contribution plans. With their buying power, we are quite confident that government pensions could dramatically level the differential in administrative costs between defined-benefit systems and defined-contribution systems. The government pensions manage portfolios presently, so there is no basis to believe that shifting the outcome of how the funds managed are distributed inherently means much higher administrative costs. The Thrift Savings Plan for federal government workers highlights this reality.

themselves with too little retirement income no matter how good the lifetime returns on their investments happen to be. New 401(k) practices have arisen in recent years, however, to account for past shortcomings. Programs such as auto-enrollment and auto-investment ensure that workers contribute the necessary funds to save for a comfortable retirement. Additionally, well-received programs such as the federal government's defined-contribution system, the Thrift Savings Plan, provide a limited number of secure investment options in order to mitigate investor risk.

If provided a clean slate free from unfunded liabilities, it is undeniable that a carefully managed defined-contribution plan, similar to those in the private sector, would save more taxpayer dollars than the defined-benefit plans currently in place. If Ohio taxpayers and lawmakers wish to finance (via a higher taxpayer contribution rate) a more generous level of retirement for government employees than private-sector Ohioans, that is a decision that they can make.

Furthermore, OPERS is squarely on the wrong side of national retirement trends. Defined-benefit plans are largely a relic of the past in the private sector due to their significant cost. In the public sector as well, defined-contribution plans are being discussed in statehouses across the country as potential solutions to public pension crises.

Just last month, Rhode Island passed sweeping pension reform legislation that introduced a mandatory defined-contribution/defined-benefit hybrid system for all public employees. California has begun debate on creating a hybrid system of its own. Michigan implemented its defined-contribution system in 1997. None of these reforms have proved to be radical or irresponsible. As Michigan has shown, even a heavily-unionized public workforce can readily transition to a defined-contribution system. Despite what OPERS and other defined-benefit plan administrators would have you believe, participants in defined-contribution plans, as seen in Michigan, are provided with a comfortable level of retirement. The 50 laboratories of democracy are consistently moving toward the defined-contribution system for a reason—it saves taxpayer dollars.

Despite these recent examples, state pension plans like OPERS remain firmly entrenched behind their defined-benefit systems and point to the slow pace of movement by government entities to defined-contribution systems as "proof" of a deficiency in those systems. This lack of rapid movement should not be a surprise. Public employee unions and their members, as recently shown by the defeat of collective bargaining reform in Ohio, are among the most powerful entrenched interests in America. The status quo feels secure, and for many decades, Ohio could afford it. Times and economics have changed. Forward-thinking states are moving toward defined-contribution plans to control costs. Ohio can either join these states, or it can choose to kick-the-can a little further down the road and await the next

pension crisis (or politicians more willing to increase the taxpayer contribution rate to the pensions[3]).

Fourthly, it should be noted that our report was very conservative in its calculation of unfunded liabilities and funding percentages. Our figure of $66 billion in unfunded liabilities was found by pulling data directly from each pension fund CAFR. But state pension funds rely on accounting standards that are disingenuous at best. Ohio's pension funds calculate their unfunded liabilities off of assumed rates of return that are set unrealistically high and that also fail to account for the risk this places on taxpayers.

Unlike public pensions, private-sector plans must calculate their liabilities using market-based accounting principles. Since the benefits paid to retirees are guaranteed by law, the return on assets should also be set at a guaranteed rate. Instead of the current eight percent return (which OPERS cannot guarantee), expected investment returns should be set at the current Treasury note rate (typically between three and four percent) to guarantee a set rate of return.

It's a system that a vast majority of economists now endorse, as well as the Federal Reserve and the Congressional Budget Office.[4] The Government Accounting Standards Board (GASB) is currently considering these accounting rule changes. Using the proposed GASB accounting rules, Ohio's total unfunded pension liability would soar from $66 billion to nearly $188 billion.[5] In other words, our report highlights the best-case scenario when a far worse reality exists.

Fifthly, OPERS continues to make the tired-out argument that it is a tremendous economic engine for the state, responsible for more than $5 billion in consumer spending within Ohio. Their statement doesn't agree with basic economics. In order to pay benefits, money has to be first taken out of the economy through taxes on Ohioans. That money could have been invested in a defined-contribution system or left in the pockets of taxpayers in the first place, and the same economic outcomes

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[3] As our report noted, two of the five pensions proposed higher taxpayer contributions rates as solutions to their unfunded liability problems. But for the change in political leadership in the Governor's Office and the Ohio House of Representatives, those solutions would have remained on the table. It is naïve for anyone to believe that when (not if) the political winds change again, the government pensions will not seek to increase the taxpayer contribution rate. History unequivocally proves that point.

[4] Frank Russek, "The Underfunding of State and Local Pension Plans," Congressional Budget Office, May 2011, at *http://www.cbo.gov/doc.cfm?index=12084* (December 14, 2011); Donald L. Kohn, "Address at the National Conference on Public Employee Retirement Systems Annual Conference" May 20, 2008, at *http://www.federalreserve.gov/newsevents/speech/kohn20080520a.htm* (December 14, 2011).

[5] Andrew G. Biggs, "An Options Pricing Method for Calculating the Market Price of Public Sector Pension Liabilities," American Enterprise Institute, at *http://www.aei.org/paper/economics/retirement/an-options-pricing-method-for-calculating-the-market-price-of-public-sector-pension-liabilities-paper* (December 13, 2011).

(i.e., consumer spending) would have occurred. As we've often noted, money does not come from the money tree, it comes from real taxes on real people.

Finally, it is important to note that all of the data used within our report was taken directly from each pension funds' publicly-available CAFR. Any discrepancies with our report stem strictly from differences in interpretation.

In the end, the debate over defined-benefit and defined-contribution retirement plans largely comes down to who bears the risk. Under defined-benefit plans, government employees face zero risk and get a generous, legally guaranteed retirement. Private-sector Ohioans, whose tax dollars fund public employee pensions, face significantly more risk in securing their own retirements. We do not advocate pulling the rug out from anyone; our public employees are a valuable asset and deserve to be done right by. All that our report advocates is that they bear some of their own retirement risk that more equitably reflects the risk born by their private sector neighbors.

Our view is that defined-benefit systems have led Ohio toward a failed fiscal policy of massive unfunded liabilities and guaranteed retirement pensions for government employees that are far more generous than the ones received by the private-sector Ohioans who pay for them. We feel that the only way to correct this imbalance and put Ohio back on a sustainable fiscal trajectory is to embrace defined-contribution solutions. While we respect Ohio's five pension plans' insistence on nibbling around the edges of reform, we feel that such a strategy does not best serve Ohio taxpayers and public employees.

In the end, it will ultimately be Ohioans and our state lawmakers who decide what type of pension reform will be implemented. Ohio's political leaders, unlike the Democratic leadership in Rhode Island, could decide just to nibble on Ohio's government pension problems, thereby ensuring Ohio remains a follower and an economic laggard. We believe a stronger set of reforms should occur and our report adds a critical and frequently unheard perspective to that debate.