The Heritage Foundation

BACKGROUNDER

No. 3190 | MAY 4, 2017

Not Your Grandfather's Pension: Why Defined Benefit Pensions Are Failing

Rachel Greszler

Abstract
Once a cornerstone of retirement security for Americans, many defined benefit pension plans are on the brink of failure. Private and public pension plans have promised trillions of dollars in benefits they cannot afford, posing serious financial risk to millions of workers and retirees and leaving taxpayers on the hook for unfunded promises. Regulatory favoritism and states' lack of rules and accountability in plan management allow politicians to play politics with pensions while benefitting personally at the expense of taxpayers and future retirees. To address these failures, workers should be given their benefits when they are earned, not decades later. Defined contribution plans would give workers ownership and control of benefits; prevent employers, unions, and governments from accumulating unfunded liabilities; and protect taxpayers. Defined benefit plans should still be an option, but Congress and state governments should require sufficient funding rules to ensure they are at least as secure—for workers, retirees, and taxpayers—as defined contribution plans.

Defined benefit pension plans have been the cornerstone of retirement security for millions of Americans, but many of those plans are now on the brink of failure. That is because the structure of these plans contributes to unaffordable promises and payments. After decades of shortsighted and often irresponsible promises and management, many current and future retirees stand to lose a significant portion of their promised benefits, and state and local taxpayers face massive public pension costs.

Social Security has $14.2 trillion in unfunded obligations;[1] state and local public pension plans have an estimated $5.6 trillion in

Key Points

- Once hailed as a cornerstone of retirement security, many private and public pension plans are on the brink of failure, with trillions of dollars in unfunded promises.
- Pension managers and politicians have put short-term interests such as votes and job security above pension beneficiaries' long-term interests.
- Conflicts of interest in defined benefit plans have enabled politicians and pension managers to pay out benefits to workers who did not earn them, fail to make adequate pension contributions, use unreasonable assumptions, and play politics with public employees' pensions.
- Separate and unequal funding rules for private-sector pensions and largely nonexistent funding rules for state and local pensions enabled these plans to promise more than they can pay.
- Congress should encourage a shift to defined contribution retirement plans, impose the same pension funding rules that apply to private pensions on union-run plans, and make the PBGC function more like a private insurance company.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3190**

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

unfunded liabilities;[2] private union (or multiemployer) pension plans have promised over $600 billion more than they can pay;[3] and non-union private plans have promised over $700 billion more than they can pay.[4] These massive unfunded benefits have accumulated in large part because of a lack of accountability, conflicting interests, and lax regulations that have permitted plans to make insufficient contributions and politicians and pension officials to use workers' and retirees' pension plans for personal gain.

Workers and retirees need to know with certainty that their promised pension benefits will be there for them, and taxpayers need to know that they will have to pick up the tab for their state and local governments' unfunded pension promises.

The only way to accomplish the former is to give workers ownership and control of their retirement savings through defined contribution plans. In addition to providing portability for workers to take their plans with them from job to job, defined contribution plans would better prepare individuals for retirement by allowing them to know with certainty the value of their account and to pass it on to their heirs. A shift to defined contribution plans for public-sector workers would also prevent taxpayers who do not have defined benefit pensions from having to finance the retirement benefits of those who do.

Addressing the massive shortfalls in defined benefit pension plans across the country will not be easy, and the benefits of reform will not be immediate. The first move should be to shift new and younger workers into defined contribution plans that provide workers with ownership and control of their funds and that—by definition—cannot be underfunded. For existing pension plans:

- Managers should impose reasonable changes to bring costs in line with benefits;
- The federal government should require private plans to use reasonable assumptions by ending their special treatment and encourage state and local plans to do the same; and
- Congress should make the Pension Benefit Guaranty Corporation (PBGC) function more like a private insurer.

Defined Benefit Plans

All retirement plans face uncertainties: How long will the person work? How long will he or she live? What level of investment returns will he or she receive? The type of retirement plan determines who bears the risks of these uncertainties.

- In defined benefit plans, employers bear most of the risks. Employers promise a certain level of benefit in retirement as part of their employees' compensation, and it is their duty to make good on that promise by setting aside sufficient funds and managing those funds well.
- In defined contribution plans, employers typically deposit a specified amount—a defined contribution—into employees' accounts, but they do not promise any specific level of benefit in retirement. Employees bear the risk of managing their savings to achieve their desired goals.

In exchange for the promise of a secure lifetime annuity benefit, workers in defined benefit plans give up control and ownership of their retirement funds. If employers do not make adequate contribu-

1. According to the 2016 Social Security Trustees report, Social Security has an $11.4 trillion deficit over the 75-year horizon, but that does not include the $2.8 trillion in trust fund IOUs that the federal government owes to Social Security. The total of these two deficits is $14.2 trillion. Romina Boccia and Rachel Greszler, "Social Security Programs Face Depletion in Near Future," The Daily Signal, June 28, 2016, http://dailysignal.com/2016/06/28/social-security-programs-face-depletion-in-near-future/.
2. Bob Williams, Jonathan Williams, Ted Lafferty, and Sarah Curry, "Unaccountable and Unaffordable 2016: Unfunded Public Pension Liabilities Near $5.6 Trillion," American Legislative Exchange Council, October 13, 2016, https://www.alec.org/publication/pensiondebt2016/ (accessed December 1, 2016).
3. Rachel Greszler, "Why a Coal Miner Pension Bailout Could Open the Door to a $600 Billion Pension Bailout for All Private Unions," Heritage Foundation *Issue Brief* No. 4600, August 15, 2016, http://www.heritage.org/research/reports/2016/08/why-a-coal-miner-pension-bailout-could-open-the-door-to-a-600-billion-pension-bailout-for-all-private-unions.
4. Pension Benefit Guaranty Corporation, *Pension Insurance Data Book*, 2014, Tables M-9, "Funding of PBGC-Insured Plans (1980–2013), Multiemployer Program," and S-44, "Funding of PBGC-Insured Plans (1980–2013), =Single-Employer Program," http://www.pbgc.gov/documents/2014-data-tables-final.pdf (accessed November 10, 2016).

tions or properly manage their pension plans, workers may be left with far lower benefits than they were promised.

Additionally, without ownership of the contributions made on their behalf, workers who live shorter lives and receive little or nothing from their pension plans lose out by not being able to pass on their unclaimed benefits to their heirs. Workers sacrifice a significant portion of their paychecks—sometimes as much as 20 percent of their pay—in return for future pension benefits, and they should not have to sacrifice this to a defined benefit system if they do not live long enough to receive the benefits for which they labored.

Since workers do not own the money contributed on their behalf, defined benefit plans can pool workers' contributions and help prevent workers from outliving their savings by transferring funds from individuals who live shorter lives to those who live longer lives. Defined benefit plans encourage workers to remain in their jobs longer in order to maximize their pension benefits. Workers who jump from job to job may never become vested in a pension system or may earn only small benefit levels.

Who Is Best Equipped to Manage Workers' Retirements?

The notion that employers or the government are better equipped to manage individual workers' retirement plans than are workers themselves is a fundamental component of defined benefit plans. Inherent conflicts of interest in defined benefit plans, combined with significantly improved access to information and ease of investment transactions, suggest that individuals are best equipped to manage their own retirement savings.

The incentive for individual savers to set aside what they will need in retirement is straightforward: If they do not save enough, it is their own financial future that is on the line. The officials and politicians responsible for managing union-run and public pension plans, however, have an incentive to put their own shortsighted interests above the long-term interests of pension beneficiaries. Since plan managers are often long gone before the promises they make come due, they can gain votes and job security by making unfunded pension promises, playing politics with pension investments, and leaving future plan managers, politicians, and taxpayers to deal with the consequences.

The incentive for individual savers to set aside what they will need in retirement is straightforward: If they do not save enough, it is their own financial future that is on the line.

When defined benefit pensions first began in the late 19th century, the government had an interest in encouraging employment-based defined benefit plans as a way to reduce poverty and thus the cost of anti-poverty government programs. Today, the federal government has its own defined benefit pension system through Social Security (another defined benefit plan, with $14 trillion in unfunded promises).

Moreover, when defined benefit pensions were created, it made some sense for employers to manage workers' savings. This was back when telephone lines had just been installed on the floor of the New York Stock Exchange.[5] Obtaining investment information would not have been simple, nor would it have been easy to make investment transactions. The average saver therefore lacked the resources and information necessary to maximize his or her retirement savings, so it made sense for employers to use their competitive advantage, through pooled resources, to set up defined benefit retirement savings plans for their employees.

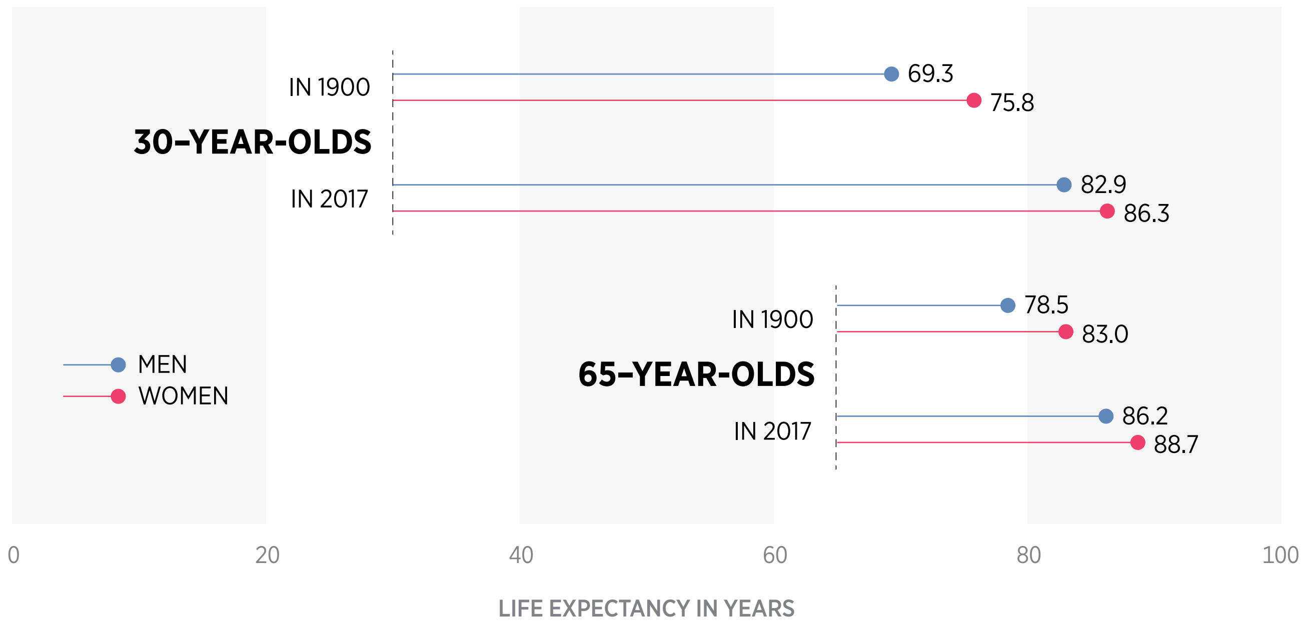
That is not the case today. Most workers have their own smart phones, complete with any number of financial and investment apps that provide a wealth of information and the ability to purchase stocks and bonds from almost anywhere in the world with the tap of a finger. This has transformed the ability of everyday Americans to manage their own retirement savings.

Even setting aside the potential conflicts of interest and political manipulation of defined benefit pension plans, employers and governments rarely manage other people's money more prudently than those people can themselves. The multitrillion-

5. Public Broadcasting Service, "Timeline: A Selected Wall Street Chronology," *American Experience*, http://www.pbs.org/wgbh/americanexperience/features/timeline/crash/ (accessed October 17, 2016).

CHART 1

Today's Longer Life Expectancy



SOURCE: Felicitie C. Bell and Michael L. Miller, "Life Tables for the United States Social Security Area," Social Security Administration, Office of the Chief Actuary, *Actuarial Study* No. 120, August 2005, Table 11, pp. 167–171, https://www.ssa.gov/oact/NOTES/pdf_studies/study120.pdf (accessed January 18, 2017).

BG3190 heritage.org

dollar shortfall in defined benefit pension systems across the United States is evidence of this.

Not Your Grandfather's Pension

Technology is not the only factor that has taken a giant leap forward. People have also made huge gains in health and life expectancy. In the early days of defined pension plans around 1900, life expectancy at age 30 (approximately the age at which workers became vested in pension systems) was 69 years for males and 76 years for females, and life expectancy for the subset of the population who actually reached age 65 was 79 years for males and 83 years for females.[6] Thus, a significant percentage of workers were never expected to collect pension benefits, and those who did collected them for about 14–18 years.

Today, life expectancy at age 30 is 83 years for males and 86 years for females, and at age 65, life expectancy is 86 years for males and 89 years for females.[7] This means that an overwhelming majority of individuals live long enough to retire and collect pension benefits, and those who do receive benefits collect them for between 21 and 24 years—roughly 50 percent longer than the first pension beneficiaries. Furthermore, with some defined benefit pensions kicking in as early as age 50 or 55, many workers collect pension benefits for three or even four decades—sometimes longer than they spent working.

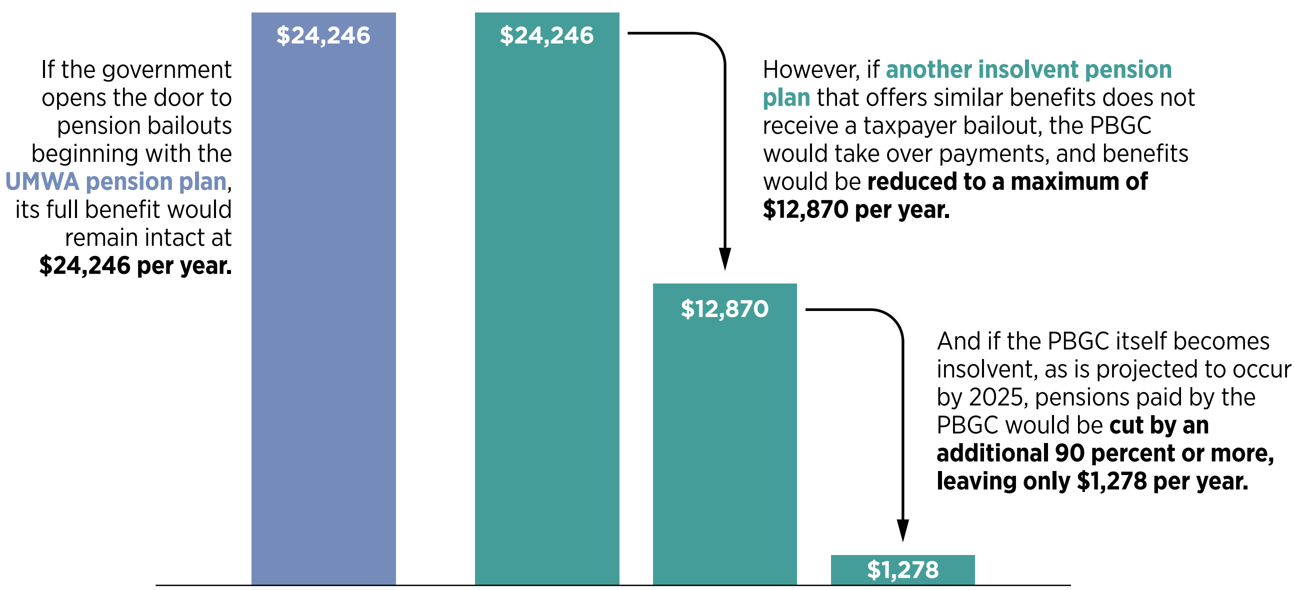
To date, defined benefit pensions have largely been a dream come true. After 30 to 40 years on the job, workers can retire in their late 50s or early 60s with potentially decades of good health and mobility ahead and collect a pension that replaces about half

6. Felicitie C. Bell and Michael L. Miller, *Life Tables for the United States Social Security Area, 1900–2100*, Social Security Administration, Office of the Chief Actuary, *Actuarial Study* No. 120, August 2005, pp. 167–171, "Table 11—Cohort Life Expectancies at Selected Exact Ages, by Sex and Year of Birth," https://www.ssa.gov/oact/NOTES/pdf_studies/study120.pdf (accessed November 13, 2016).

7. Ibid.

CHART 2

Pension Bailouts Would Unfairly Preserve Select Workers' Benefits While Others Face Massive Pension Cuts



SOURCES: Author's calculations based on the UMWA's pension benefits for a 62-year-old worker who retires in 2016 with 30 years of work history. Data on UMWA's pension eligibility are from UMWA Health and Retirement Funds, Pension Eligibility Requirements, http://www.umwafunds.org/Pension-Survivor-Health/Pages/Eligibility-Requirements.aspx (accessed March 9, 2016). Data on pension benefit cuts are based on PBGC's guaranteed level and U.S. Government Accountability Office, "Private Pensions: Multiemployer Plans and PBGC Face Urgent Challenges," testimony before the Subcommittee on Health, Employment, Labor and Pensions, Committee on Education and the Workforce, House of Representatives, March 5, 2013, http://www.gao.gov/assets/660/652687.pdf (accessed March 10, 2016).

BG3190 heritage.org

or more of their pre-retirement income (not including Social Security benefits).[8]

This dream come true is proving too good to be true. After paying out more in benefits than workers actually earned, failing to adjust contributions or benefits adequately in response to changes in life expectancies and investment returns, using unreasonable assumptions to shortchange necessary contributions, and sometimes engaging in politicized management decisions, many defined benefit pension plans cannot afford to keep their promises.

Defined benefit plans that provided security and generous benefits for past and current retirees now embody uncertainty and steep costs for current and future workers and the taxpayers who pay for public pensions. As many pension plans struggle to remain solvent, current workers and taxpayers will be forced to pay for overpromised and underfunded defined benefit pensions. Additionally, some workers—namely, private-sector union workers who do not yet have a taxpayer backing behind them—will receive only a portion of what they were promised.

8. The average private-sector defined benefit pension replaced 47.3 percent of workers' pre-retirement incomes. Most public-sector defined benefit pensions replace a significantly larger portion of workers' pre-retirement incomes. Patricia P. Martin, "Comparing Replacement Rates Under Private and Federal Retirement Systems," *Social Security Bulletin*, Vol. 65, No. 1 (2003/2004), https://www.ssa.gov/policy/docs/ssb/v65n1/v65n1p17.html (accessed November 10, 2016).

Today's defined benefit pensions are not those of our grandfathers.

Defined benefit plans that provided security and generous benefits for past and current retirees now embody uncertainty and steep costs for current and future workers and the taxpayers who pay for public pensions.

What Happens When a Defined Benefit Pension Becomes Insolvent?

When a defined benefit pension plan becomes insolvent, what happens next depends on the type of plan. Private, single-employer pension plans are turned over to the Pension Benefit Guaranty Corporation, a public agency but one that is self-funded and cannot use taxpayer dollars. In most cases, the PBGC insures and pays out close to 100 percent of promised benefits for single-employer plans.[9]

When union-run or multiemployer pension plans go bankrupt, the PBGC does not take over the plan as it does with single-employer ones, but it does provide the plan with funds to pay insured benefits. The PBGC's guarantee for multiemployer plans is significantly lower, however, because the existence of multiple employers within a plan is supposed to serve as a first level of insurance (PBGC multiemployer premiums are also significantly lower). PBGC benefits for multiemployer plans are capped at $12,870 per year for a worker with a 30-year career.

It should be noted, however, that the first steps in the process to pass a taxpayer-funded bailout of a private, union-run pension plan have already been taken. On September 22, 2016, the Senate Finance Committee approved a bill (S. 1714, the Miners Protection Act) that would provide the United Mine Workers of America (UMWA) with a taxpayer-financed bailout to cover its $5.6 billion in unfunded pensions.[10] This would provide the UMWA pension plan and, potentially, any other politically influential plans that follow suit with 100 percent of their promised benefits while other insolvent plans receive only PBGC-guaranteed benefits.

Although workers and retirees in failed pension plans are supposed to receive PBGC-insured benefits, the PBGC's multiemployer plan is on track to become insolvent itself in 2025. Absent significant reforms or a taxpayer bailout, the PBGC will be able to pay only about 10 percent to 15 percent of insured benefits after it becomes insolvent.[11]

If state or local pension plans become insolvent, the citizens of those states or localities are on the hook to pay for their unfunded promises.

If state or local pension plans become insolvent, the citizens of those states or localities are on the hook to pay for their unfunded promises. This can mean tax increases, reductions in services, or both. A recent report from the American Legislative Exchange Council estimated that state and local governments have promised $5.6 trillion more in public pension benefits than they have set aside to pay. At $17,427 for every man, woman, and child in America, the necessary tax increases and service cuts will be significant.[12] State and local taxpayers will likely be on the hook for these unfunded promises, but federal taxpayers could be on the hook if distressed state and local governments seek and receive federal bailouts.

9. The PBGC's single-employer program maximum annual benefit is about $64,400 for a 65-year-old in 2017. News release, "PBGC Guarantee Limit for Single-Employer Plans Increases for 2017," Pension Benefit Guaranty Corporation, October 28, 2016, http://www.pbgc.gov/news/press/releases/pr16-16.html (accessed January 16, 2017).
10. Rachel Greszler, "GOP Senators Side with Democrats to Bail Out Union's Pension Fund," The Daily Signal, September 22, 2016, http://dailysignal.com/2016/09/22/gop-senators-side-with-democrats-to-bail-out-unions-pension-fund/.
11. Rachel Greszler, "Bankrupt Pensions and Insolvent Pension Insurance: The Case of Multiemployer Pensions and the PBGC's Multiemployer Program," Heritage Foundation *Backgrounder* No. 3029, July 30, 2015, http://www.heritage.org/research/reports/2015/07/bankrupt-pensions-and-insolvent-pension-insurance-the-case-of-multiemployer-pensions-and-the-pbgcs-multiemployer-program.
12. Williams et al., "Unaccountable and Unaffordable 2016."

How Did Defined Benefit Pensions Accumulate Such Massive Debts?

Defined benefit pensions are promises, and it is always easier—especially for politicians—to make promises than it is to keep them. Despite seemingly good intentions of providing retirement security, defined benefit pension plans have all the wrong incentives, and many plan types lack sufficient legal requirements to ensure proper funding. These adverse incentives and inadequate rules set the stage for widespread pension failures.

Paying Out Benefits Before They Are Earned. In theory, the average worker's pension benefit should be equal to the contributions made on his or her behalf plus the earnings of those contributions over time. Union-run (or multiemployer) and public pension plans, however, have an incentive to pay out pension benefits to workers who did not earn them because union officials and politicians are elected by their members and constituents, and promising unearned pension benefits helps union leaders and politicians to get elected.

Take the UMWA, for example. In 1946, the union established a benefit fund that included future pension benefits. The union wanted to begin paying benefits to retirees immediately, transferring contributions made on behalf of current workers to current and soon-to-be retirees who did not earn pension benefits. It fought so hard for immediate pension payments, including leading the miners to walk out of negotiations, that the plan's neutral trustee resigned in frustration. The union got its way, and the first pension check was issued in 1948.[13]

Windfall pension benefits are great for workers who receive them without sacrificing a portion of their salary, but they hurt workers and taxpayers who have to pay for those benefits without receiving anything in return. By paying out benefits before they were earned, many pension plans essentially dug themselves into deep holes from the beginning, making it extremely difficult to succeed in the long run.

Promising and Paying Excessive Benefits. Not all defined benefit pension plans intentionally paid out benefits before they came due, but most have paid excessive benefits along the way. That is, they have paid out more than the equivalent of what they set aside. Furthermore, many state and local pension plans have knowingly failed to make adequate pension contributions, sometimes even skipping them entirely. In 2013, only 20 states made their annually required contributions (ARCs).[14]

Excessive benefits create a double whammy for pensions' solvency: They strip workers of contributions made on their behalf by paying them to existing retirees, and they keep those contributions from growing over time because they are paid out before they can be invested and earn positive returns.

Even if politicians, union trustees, and plan managers realize that their pension payments and promises create an unsustainable system, they know that future politicians and taxpayers will find it almost impossible not to keep those promises. It is a bit like one parent bringing home a puppy and relying on the other parent to take the dog back to the pound—except that it is a lot easier to take away a puppy after a couple hours of bonding than it is to take a pension away from someone has worked for it his or her entire career.

While windfall benefits are great for pension recipients who receive them and for the politicians and plan administrators who gain favor by promising them, there is no such thing as free money. Workers and taxpayers will ultimately pay the costs of unfunded pension promises. To shield workers and taxpayers from these costs, pension plans—particularly union-run and public plans that have lenient or no funding rules—should impose stricter funding requirements and enforce greater accountability and legal liability on employers, politicians, actuaries, and trustees who play a role in managing defined benefit pension plans.

Unreasonable Assumptions. Plans end up promising more than they can reasonably pay by using unreasonable assumptions. Required or recommended contributions depend on such factors as life expectancy, the rate of return on investments,

13. Rachel Greszler, "Congress Can Help Pensioners, But Not Through a Bailout," Heritage Foundation *Issue Brief* No. 4529, March 14, 2016, http://www.heritage.org/research/reports/2016/03/congress-can-help-pensioners-but-not-through-a-bailout. See also "UMWA Health and Retirement Funds Explained: A Brief History of UMWA Health and Retirement Funds," Keep the Promise to the Coal Miners blog, October 28, 2004, http://keepthepromisetothecoalminers.blogspot.com/2004/10/umwa-health-and-retirement-funds.html (accessed January 17, 2017).

14. Pew Charitable Trusts, "The State Pensions Funding Gap: Challenges Persist," July 2015, http://www.pewtrusts.org/~/media/assets/2015/07/pewstates_statepensiondebtbrief_final.pdf?la=en (accessed January 17, 2017).

and workers' earnings history and job tenure. Life expectancies have risen substantially since most defined benefit plans began, yet many plans have continued to use decades-old mortality tables. Moreover, stock market returns have varied significantly over time, yet plans continue to use high rates of return that reflect a level of risk that is much greater than the benefits they promise. When allowed by law (for union-run and public-sector plans), pension plans tend to maintain unrealistic assumptions, because shifting to more reasonable ones would require significant increases in contributions or reductions in benefit accruals.

Most union-run and state and local pension plans use an assumed rate of return between 7.5 percent and 8 percent, almost double the approximately 4 percent to 5 percent that single-employer private pension plans are required to use, but state and local and union-run pensions are allowed to use whatever rate they believe is "reasonable."

Most union-run and state and local pension plans use an assumed rate of return between 7.5 percent and 8 percent. These rates are almost double the approximately 4 percent to 5 percent rate that single-employer private pension plans are required to use, but state and local and union-run pensions are allowed to use whatever rate they believe is "reasonable."

Economists universally agree that a 7 percent to 8 percent return is not a reasonable assumption, not because public pensions cannot achieve those returns, but because return assumptions must reflect promised benefits instead of the assets used to pay those benefits. Since plans provide near-certain benefit payments, they should use near-certain or riskless return assumptions.

According to then-Federal Reserve Board Vice Chairman Donald Kohn:

> While economists are famous for disagreeing with each other on virtually every other conceivable issue, when it comes to this one there is no professional disagreement: The only appropriate way to calculate the present value of a very-low-risk liability is to use a very-low-risk discount rate.[15]

Federal Reserve Board Director of Research David W. Wilcox agreed: "There's only one conceptually right answer to how you discount [public pension promises]. You use discount rates that are free of credit risk."[16]

United States Treasury bonds are a proxy for a riskless return. Currently, the 20-year Treasury yield is about 2.78 percent.[17] Returns on private equities are much higher—approximately 6 percent to 8 percent—but represent significantly riskier investments. Average returns are not actual returns; 50 percent of the time, returns are higher than the average, and 50 percent of the time, they are lower. Unless workers are happy with only a 50 percent chance of receiving the full value of their promised benefit, pension plans should assume significantly more conservative rates of return.

The problem for pension plans is that shifting to a more reasonable rate of return would require huge increases in contributions. According to an American Enterprise Institute analysis that examined actuarial reports from 20 state and local pension plans across five states, a one percentage point reduction in the assumed rate of return led to a 36 percent increase in the normal cost of the plan.[18] Similarly, the Government Accountability Office (GAO) has found that if state and local pension plans reduced their assumption by about three percentage points, from the average public plan assumption of 7.72 per-

15. Andrew G. Biggs and Jason Richwine, "Overpaid or Underpaid? A State-by-State Ranking of Public-Employee Compensation," American Enterprise Institute *Economic Policy Working Paper* No. 2014-04, April 24, 2014, https://www.aei.org/publication/overpaid-or-underpaid-a-state-by-state-ranking-of-public-employee-compensation/ (accessed January 16, 2017).
16. Ibid.
17. As of December 2, 2016, the 20-year Treasury yield was 2.78 percent. U.S. Department of the Treasury, Resource Center, "Daily Treasury Yield Curve Rates," https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield (accessed January 16, 2017).
18. Biggs and Richwine, "Overpaid or Underpaid?"

cent to the average single-employer plan assumption of 4.88 percent, the present value of their benefits due in 15 years would be nearly 50 percent higher.[19] In other words, they would have to increase their contributions by 50 percent. The difference would be even larger for benefits due more than 15 years in the future.

While plans can save thousands of dollars per worker each year by assuming higher returns, they cannot assume those higher returns into existence. If pension returns fall short of their assumptions—a 50 percent likelihood when using average investment returns—plans end up short of the assets they need to pay their liabilities.

While plans can save thousands of dollars per worker each year by assuming higher returns, they cannot assume those higher returns into existence.

Despite achieving significantly lower-than-assumed investment returns in many years, multiemployer and public pension plans have failed to adjust their assumptions to ensure that they can keep their promised benefits. If unreasonable assumptions lead to such massive pension underfunding, why are plans allowed to use those unreasonable assumptions?

Separate and Unequal Funding Rules. When the Studebaker auto plant in South Bend, Indiana, closed its doors in 1963 and its workers lost some or all of their promised pension benefits, Congress responded by passing the Employee Retirement and Income Security Act (ERISA) of 1974 to help prevent similar pension plan failures. ERISA established funding rules for private-sector pension plans, specifying certain requirements such as interest rate assumptions as well as other administrative features like vesting rules.

ERISA created two sets of rules, however: one set for single-employer plans (operated by a single company or employer) and another significantly more lenient set for multiemployer, or union-run, pension plans. While single-employer plans are required to use a relatively conservative interest rate assumption based on market rates, multiemployer plans can effectively use whatever interest rate assumption they want to use. Consequently, multiemployer plans consistently use interest rate assumptions that are nearly twice the rates required for single-employer plans.

While higher assumptions allow multiemployer plans to contribute significantly less than single-employer plans contribute to provide exactly the same benefits, multiemployer plans do not actually achieve higher returns than single-employer plans achieve, so they have accumulated significant shortfalls.

In addition to lax assumption rules, the worst-funded multiemployer plans have been treated leniently with respect to required contributions. Under the Pension Protection Act (PPA) of 2006 and the Kline–Miller Multiemployer Pension Reform Act (MPRA) of 2014, plans deemed to be in "critical" or "critical and declining" financial status (funding ratios below 65 percent and insolvency expected within 15 years) were effectively exempted from funding rules.[20] Instead of cutting the losses on these plans and preventing them from digging themselves into even deeper holes, Congress effectively allowed the worst-funded plans to exacerbate their demise.

There is no reason why union-run pension plans and single-employer plans should be treated differently. Congress should end the preferential treatment of multiemployer plans and subject them to the same rules and requirements that apply to single-employer plans. In addition, plans that are so poorly funded that they have no hope of becoming solvent should be closed and turned over to the PBGC to pay out insured benefits.[21]

19. U.S. Government Accountability Office, *Pension Plan Valuation: Views on Using Multiple Measures to Offer a More Complete Financial Picture*, GAO-14-264, September 2014, http://www.gao.gov/assets/670/666287.pdf (accessed January 16, 2017).

20. Andrew G. Biggs, "The Multiemployer Pension Plan System: Recent Reforms and Current Challenges," statement before the Committee on Finance, U.S. Senate, March 1, 2016, http://www.finance.senate.gov/imo/media/doc/03012016%20Biggs%20SFC%20testimony%20on%20multiemployer%20pensions.pdf (accessed January 17, 2017).

21. Rachel Greszler, "Congress Needs to Address the PBGC's Multiemployer Program Deficit Now," Heritage Foundation *Issue Brief* No. 4610, September 13, 2016, http://www.heritage.org/research/reports/2016/09/congress-needs-to-address-the-pbgcs-multiemployer-program-deficit-now.

Nonexistent State and Local Funding Rules. While the federal government applies inconsistent funding rules to private pensions, state and local government pension plans have almost no rules. States can impose their own funding rules, but most do not do so.

When establishing funding levels, most state and local pension plans assume excessive rates of returns between 7.5 percent and 8 percent instead of a more appropriate rate between 4 percent and 5 percent or even lower. Moreover, states' annually required contributions are merely recommended rather than required. In 2013, 20 states failed to make their full ARC payments with no consequences other than racking up more pension debt.[22]

> **Shorting or skipping public pension contributions is a way for state and local governments to bypass constitutional balanced budget requirements.**

Shorting or skipping public pension contributions is a way for state and local governments to bypass constitutional balanced budget requirements. Normally, state and local governments have to raise new debt or cut spending if they want to pay for a new program or policy, and there are restrictions on deficit-financed spending. Reducing or skipping pension contributions, however, provides an easy avenue by which to increase future taxpayers' obligations without technically issuing new debt or adding to existing debt.

Shortsighted and Selfish Interests. When companies or governments promise pension benefits, they are committing themselves to paying out future costs. If a company that offers its own private pension plan promises more than it sets aside to pay, those unfunded promises can bankrupt the company. That is not always the case for multiemployer pensions, and it is rarely the case for state and local governments (states cannot declare bankruptcy). Moreover, the long lag time between promises made and promises delivered means that union representatives, politicians, and other pension officials are often long gone by the time the unfunded benefits they promised come due.

The consequences of poor pension management are particularly far removed for the trustees of multiemployer pension plans. When a union-run pension becomes insolvent, the plan's managers—the same ones that oversaw its demise—keep their jobs and are paid by the PBGC to administer their plan's insured benefits. Executives that run businesses into the ground do not continue to collect their paychecks at the expense of a federal agency; private union officials and pension plan trustees should not be able to do so either.

Playing Politics with Pensions. State and local public pension plans across the United States are in a sorry state, owing an estimated $5.6 trillion more than they have set aside to pay.[23] This is largely a consequence of states' lack of regulation and accountability, which allows politicians and union officials to use public pension plans for their own personal and political gain.

> **Executives that run businesses into the ground do not continue to collect their paychecks at the expense of a federal agency; private union officials and pension plan trustees should not be able to do so either.**

Politicians routinely make promises that extend well beyond their tenure, committing future taxpayers' money for causes that help them to buy votes and popularity. Decades of unfunded pension promises are beginning to bankrupt local and state governments.

In Philadelphia, for example, then-councilman and now-mayor Jim Kenney helped to pass a law that expanded pension bonuses to retirees by lifting the requirement that the plan must be at least 76.7 percent funded. Despite more than $5.7 billion in unfunded liabilities and a $218 million loss in fis-

22. Williams et al., "Unaccountable and Unaffordable 2016."
23. Ibid.

cal year 2015, Philadelphia's public pension plan paid out nearly $70 million in pension bonuses over the past two years.[24] Meanwhile, the city's school system has experienced deep budget cuts, and children's education is suffering. According to Superintendent Dr. William R. Hite, Jr., the district's recent budget woes reflect the consequences of shortsighted fiscal decisions in the past, including unfunded pension promises.[25] As Lawrence Tabas, chairman of the Pennsylvania Intergovernmental Cooperation Authority (the state-appointed overseer of the city's finances) has said, the city "is in a crisis," and "everything will end up getting cut as larger and larger portions of every dollar go to the pensions."[26]

In Illinois, taxpayers are paying the price for past politicians' unfunded pension promises that are now coming due. According to the Illinois Policy Institute, 90 percent of the state's recent $32 billion tax hike went toward public pensions, and in the city of Chicago, 89 cents of every new dollar in education spending from 2009 to 2014 went toward teachers' pensions, leaving only 11 cents for classrooms.[27]

Regrettably, the problems afflicting public pensions go beyond unfunded promises. Politicians and union officials also routinely engage in pension cronyism by using public pension investments to reward individuals and businesses they like, bully and punish those they do not like, and allow private businesses to buy access to public pension investments through political donations and lobbying. Instead of looking out for the best interests of public workers and retirees, these politicians and pension officials are sacrificing billions of dollars each year in lost returns through second-rate investments. Investing based on politics instead of performance costs the average pension fund over $200 million a year.[28]

Politicians and union officials routinely use public pension investments to reward individuals and businesses they like, bully and punish those they do not like, and allow private businesses to buy access to public pension investments through political donations and lobbying.

One way public pension funds sacrifice returns is by making economically targeted investments (ETIs) in an attempt to stimulate local economies. ETIs routinely produce significantly lower returns that result in lost pension earnings. A particularly egregious example of the reckless use of ETIs is Alabama's investment in a troubled oil repair and shipbuilding firm, Signal International.[29] Two of Alabama's pension funds invested $21 million in Signal. Then, following an 11 percent loss of their investment over three years, the funds loaned Signal $73 million. Shortly thereafter, Signal was charged with and paid $21 million to settle what was called "one of the largest cases of labor trafficking in modern times."[30] Signal entered bankruptcy and was purchased by one of Alabama's pension funds.

Another way state and local pensions sacrifice investment returns is through political kickbacks:

24. Claudia Vargas, "City Paying Pension Bonuses Despite Vast Shortfall," *The Philadelphia Inquirer*, February 26, 2016, http://www.philly.com/philly/news/politics/20160227_City_paying_pension_bonuses_despite_vast_shortfall.html (accessed October 31, 2016).
25. Trip Gabriel, "Budget Cuts Reach Bone for Philadelphia Schools," *The New York Times*, June 16, 2013, http://www.nytimes.com/2013/06/17/education/budget-cuts-reach-bone-for-philadelphia-schools.html (accessed October 31, 2016).
26. Romy Varghese, "Philadelphia Pays Retirees Bonus Amid Pension Gap," Bloomberg News, February 5, 2015, http://www.bloomberg.com/news/articles/2015-02-06/philadelphia-pays-retirees-bonus-amid-pension-gap-muni-credit (accessed October 31, 2016).
27. Ted Dabrowski and John Klingner, "Pensions vs. Schools: Since 2009, 89 Cents of Every New Dollar for Education Goes to Teacher Pensions," Illinois Policy Institute *Special Report*, January 2016, https://d2dv7hze646xr.cloudfront.net/wp-content/uploads/2016/01/PensionsvsSchools.pdf (accessed January 17, 2017).
28. Theodore Lafferty, Kati Siconolfi, Jonathan Williams, and Elliot Young, *Keeping the Promise: Getting Politics Out of Pensions*, American Legislative Exchange Council, Center for State Fiscal Reform, December 2016, https://www.alec.org/app/uploads/2016/12/Getting-Politics-Out-Of-Pensions-Final-WEB.pdf (accessed January 17, 2017).
29. Ibid.
30. Peg Brickley, "Accused of Labor Trafficking, Oil-Rig Repairer Files for Bankruptcy," *The Wall Street Journal*, July 13, 2015, http://www.wsj.com/articles/signal-international-files-for-bankruptcy-1436787503 (accessed December 19, 2016).

allowing companies to buy access to pension investments by making campaign contributions to pension officials' favored politicians or actively lobbying the pension fund. California's Public Employees' Retirement System (CalPERS) suffered massive losses from political investments, largely at the helm of union leader and CalPERS board member Charles Valdes. Despite having no investment experience and twice filing for personal bankruptcy, Valdes spent 25 years as a CalPERS board member and 13 as Investment Committee chairman. Valdes added significantly to CalPERS's deficits by granting investment contracts to political donors and engaging in suspect behavior with other board members. As a result, CalPERS had one of the worst investment performances of any public pension fund during his chairmanship.[31]

So-called pay-to-play schemes are another way pension cronyism reduces investment returns. In these arrangements, private equity firms pay a hefty sum to politically connected individuals, or "placement agents," in return for access to state pension fund investments. Lawyers for Hank Morris, a top political consultant to now-disgraced former State Controller Alan Hevesi, essentially argued that there was nothing illegal (at least not at the time) about pay-to-play schemes and that "everybody's doing it."[32] The Securities and Exchange Commission has cracked down on political contributions from investment companies and managers who stand to gain from access to public pension investments, but problems still exist.

There also have been outright criminal actions involving state pension funds. Former CalPERS chief executive Fred Buenrostro, Jr., pleaded guilty to taking a bribe from a placement agent firm headed by former Los Angeles Deputy Mayor Alfred Villalobos. In exchange for $200,000 in cash, a worldwide trip, and payment for his daughter's wedding costs, Buenrostro channeled $3 billion in pension investments to a particular private equity firm, Apollo Global Management.

Finally, some pension funds have recently taken on political crusades aimed at advancing particular political interests or causes. The most common example is the decision by a number of pension funds to divest from energy companies. Since divestment is based on a political agenda instead of companies' performance, it should come as no surprise that it reduces pensions' rates of return. A hypothetical portfolio showed that, compared to no divestment, divestment from energy products resulted in a 23 percent loss over five years.[33]

In some cases, pension funds' political crusades have become personal, targeting individuals based on their political beliefs. For example, the American Federation of Teachers (AFT) used its influence over an estimated $1 trillion in pension assets to blacklist about three dozen individual hedge fund managers who donated to causes and organizations that the AFT does not like. Consequently, pension funds in at least seven states divested their pensions from these hedge fund managers to some degree.[34]

Conflicts of interest do exist between private savers and investment advisers, but putting politicians in charge of workers' retirement savings will only exacerbate those conflicts.

The Demise of Defined Benefit Pension Plans

Ultimately, someone will bear the multitrillion-dollar cost of defined benefit pension plans' unfunded promises. Some retirees will receive less than they were promised, some workers will hand over an undue portion of their compensation for pension costs, and virtually all taxpayers and citizens will pay more in taxes and receive less in services in order to cover underfunded pension promises.

The consequences of defined benefit pension shortfalls—lost security, lower pensions and paychecks, and higher taxes—will not go unnoticed. Fortunately, many private companies have already shifted away from defined benefit pensions and toward defined contribution plans that eliminate

31. Lafferty et al., "Keeping the Promise."

32. Kenneth Lovett, "Former Controller Alan Hevesi Consultant's Team: 'Pay-to-Play' Is Ugly, but Not Illegal," *New York Daily News*, April 12, 2010, http://www.nydailynews.com/news/controller-alan-hevesi-consultant-team-pay-to-play-ugly-not-illegal-article-1.169212 (accessed November 1, 2016).

33. Lafferty et al., "Keeping the Promise."

34. Ibid.

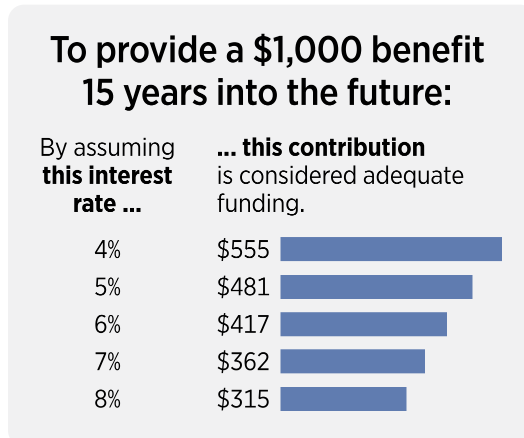
companies' and taxpayers' risks. While the risk of defined contribution plans is borne by workers themselves and defined contribution plans do not guarantee a set amount of income in retirement, they do promise workers that their retirement savings will be their own and cannot be bartered away by shortsighted politicians or imprudent plan managers.

The consequences of defined benefit pension shortfalls—lost security, lower pensions and paychecks, and higher taxes—will not go unnoticed.

CHART 3

Understating Liabilities

By using higher interest rate assumptions, multiemployer plans can understate their liabilities and contribute less than necessary to fund promised benefits.



SOURCE: U.S. Government Accountability Office, "Pension Plan Valuation: Views on Using Multiple Measures to Offer a More Complete Financial Picture," September 2014, http://www.gao.gov/assets/670/666287.pdf (accessed August 16, 2016).

BG3190 heritage.org

The Long Road to Reform. Regrettably, just as the inevitable demise of defined benefit pension plans' excessive promises has taken decades to occur, getting out from under these plans' massive unfunded liabilities will also take decades. Trillions of dollars in promises have already been made. Pension reform can stop the bleeding, but it cannot replace the blood that has been lost.

The most constructive step that employers with unfunded pension obligations can take is to shift all new and younger workers to defined contribution systems and provide the same option for middle-age and older workers. To the extent possible, workers should not lose any pension benefits they have already accrued, but future retirement contributions should not add to pension deficits. They should either be defined contributions into workers' private plans or adequate to pay promised benefits based on reasonable assumptions. While this will gradually decrease employers' and taxpayers' risk portfolios over time, the financial relief of pension reform will primarily come decades into the future, once unfunded benefits are no longer due.

Legal Restrictions and Ethical Considerations. Pension plans face both legal restrictions and ethical considerations in terms of reducing benefits. Twenty-one states have protections—usually contractual—that prevent the government from reducing past or future pension benefits; 11 states prevent past and potentially future benefit changes; 16 prevent changes only for past accruals; and two have few restrictions.[35]

Under the strictest interpretation, the Illinois Supreme Court ruled that the state and its municipalities cannot change any terms of its employees' pension, including even their future benefit accruals. While Illinois cannot do anything to change or reduce pension benefits for existing workers, some states can change certain aspects of current workers' pension benefits.

Even though New Jersey is prohibited from changing accrued benefits, the state Supreme Court upheld a freeze on its pensioners' cost of living adjustments (COLAs), reasoning that COLAs are not explicitly part of employees' "non-forfeitable rights." This freeze is estimated to save the state more than

35. Alicia H. Munnell and Laura Quinby, "Legal Constraints on Changes in State and Local Pensions," Center for Retirement Research at Boston College, *Issue in Brief* No. 25, August 2012, http://crr.bc.edu/wp-content/uploads/2012/08/slp_25.pdf (accessed November 29, 2016).

$70 billion. COLA reductions may be one of the only changes that many states can make to reduce costs for existing workers and retirees.

Other options for changing future benefit accruals include:

- **Increasing** the retirement eligibility age, eventually bringing it in line with Social Security's and indexing it to life expectancy;
- **Reducing** benefit accrual rates or requiring employees to contribute more to their pensions;
- **Using** a more accurate measure of average earnings to prevent final salary spikes; and
- **Capping** pension payments at a reasonable level so that, in systems like Chicago's teachers' plan, the average retiree does not receive a multimillion-dollar pension.[36]

Regardless of states' legal restrictions on pension reform, all states can and should strengthen the rules and regulations that govern their own public-sector pensions so that politics does not compromise public employees' pensions. State and local pensions are not subject to the ERISA, and states have not adopted sufficient rules to provide public-sector pensions with the same protections as private-sector retirement plans. States should therefore:

- **Strengthen** the fiduciary responsibilities of pension officials to require them to act exclusively in the best interest of participants;
- **Require** greater oversight and transparency of public pension operations; and
- **Diversify** pension boards to represent all stakeholders, including taxpayers.

Some private multiemployer pension plans have the ability, through the Multiemployer Pension Reform Act of 2014, to reduce certain benefits if doing so can prevent the plans from becoming insolvent. While the cuts would reduce already accrued benefits, they would preserve benefits at a higher level than pensioners would receive from the PBGC if their plans were to fail. (Only plans that are projected to fail within the next 15 to 20 years are eligible to reduce benefits.)

However, at least one large plan—the Teamsters Central States Pension Fund—met a political roadblock when it set out to do precisely what the MPRA specified by applying for a benefit reduction. The Obama Administration denied the Teamsters' application for benefit reductions in what appeared to be a political move to avoid pension cuts in an election year. Ironically, the Treasury cited the plan's use of a 7.5 percent interest rate as "too optimistic and unreasonable," yet this is the very same rate that federal regulations allow the Teamsters to use when estimating their contributions and unfunded liabilities.[37]

Options for Reform

Shift to Defined Contribution Plans. The most important and most consequential step that current defined benefit plans can take to reduce and eliminate their unfunded liabilities is to shift new workers into defined contribution plans and allow existing workers the option to shift to defined contribution plans. While this would reduce defined benefit plans' incoming revenues, preventing them from using current workers' contributions to fund current retirees' benefits, it would also prevent those plans from incurring new unfunded liabilities for new workers and significantly reduce employers' risks. It also would force private companies and state and local governments to operate in a more sustainable manner, because retirement contributions would have to be paid in the year they are earned instead of decades later.

For workers, defined contribution retirement plans provide ownership and control that defined benefit plans lack. Not only are workers able to choose their investments according to their goals, but they are able to view their savings whenever they want to do so and estimate how much those savings will provide in retirement. Moreover, if workers die earlier than expected or do not need all of their retirement

36. Ted Dabrowski and John Klingner, "11 Things You Need to Know About Chicago Teacher Pensions," Illinois Policy, March 1, 2016, https://www.illinoispolicy.org/11-things-you-need-to-know-about-chicago-teacher-pensions/ (accessed November 29, 2016).

37. Rick Romell, "Federal Officials Reject Plan to Cut Teamster Pensions," Delawareonline, May 6, 2016, http://www.delawareonline.com/story/money/nation-now/2016/05/06/teamsters-pensions/84032206/ (accessed November 29, 2016).

funds, they can pass their balances on to their heirs.

Make Reasonable Changes in Existing Defined Benefit Plans. The degree to which governments or employers are able to reform their defined benefit pension plans depends on the type of plan and (for public plans) the state's constitution and court's interpretation of its constitution.

Currently, some states are barred from changing any terms of employees' promised pensions, even in the future. Other states prohibit changes in benefits that workers have already accrued but allow for reform of future benefit accruals (such as changing the contribution rate for future earnings). Changes in COLAs may be possible for many states, even if they prohibit changes in past and future benefits.

Requiring state and local governments that use the tax deduction to disclose their pension liabilities based on uniform and reasonable accounting methods similar to those required by private, single-employer pension plans would give investors a more accurate representation of the ability of state and local governments to repay their debts.

Private pension plans can typically change future benefit accruals, but they cannot renege on promises already accrued. However, the MPRA does allow certain plans to implement limited benefit cuts.

Reasonable reforms that public and private plans should consider, depending on their legal limitations, include:

- **Closing** plans to new beneficiaries;
- **Raising** retirement eligibility ages for younger workers;
- **Freezing or modifying** COLAs;
- **Changing** benefit computations to prevent income spiking in workers' final years;
- **Setting** a maximum pension amount; and
- **Requiring** workers to contribute more to their plans.

Encourage State and Local Governments to Use Reasonable Assumptions. State and local governments should themselves impose funding rules and requirements that would prevent politicians and plan officials from playing politics with pensions and committing future taxpayers to excessive obligations. Most have not done so, however, because they lack the incentive to impose such limits.

While it is not the federal government's role to dictate state and local governments' terms of employment, Washington does have a role in state and local bond issuances through the federal income tax deduction for interest earned on those bonds. Pension obligations are a large determinant of state and local governments' ability to repay their bonds. If the federal government is going to continue to subsidize state and local debt, state and local governments that use the tax deduction should be required to disclose their pension liabilities based on uniform and reasonable accounting methods similar to those required by private, single-employer pension plans. Not only would this encourage better funding of state and local pensions, but it would give investors a more accurate representation of the ability of state and local governments to repay their debts.

Make the Pension Benefit Guaranty Corporation Function More Like a Private Insurer. Since the PBGC is the backstop to failed pensions, its solvency is critical to the financial well-being of the beneficiaries of failed pension plans. To increase the PBGC's ability to pay insured benefits without a taxpayer bailout, Congress should:

- **Allow** the PBGC to set its own premiums, including a variable-rate premium for PBGC's multiemployer program;
- **Require** the PBGC to take over failed multiemployer plans as it does for failed single-employer plans; and
- **Have** the PBGC preemptively take over critical and declining multiemployer plans, or else require critical and declining plans to implement cuts as allowed in the MPRA, even if those cuts would not make the plans fully solvent over the specified period.

While Congress should reform the PBGC so that it can pay its already insured benefits, Members should consider getting out of the insurance business and allowing private pension plans to purchase private pension insurance so long as it meets a specified standard. Private-sector insurance would help to discipline pension plans by rewarding well-funded plans with low premiums and penalizing poorly funded ones with high premiums. Private insurance would also drastically reduce the risk of a taxpayer-financed bailout of private pensions or the PBGC.

End the Special Treatment of Union-Run, Multiemployer Plans. Union-run, or multiemployer, plans receive regulatory favoritism that gives them dangerous leeway in setting assumptions that govern their financial solvency. There is no reason to apply different sets of rules and regulations to multiemployer defined benefit plans and single-employer plans. If anything, administrators of multiemployer plans have less of a stake in ensuring the long-run solvency of their plans than do the administrators of single-employer pension plans. Multiemployer plans may therefore warrant even stricter rules.

Congress should gradually adjust the funding rules and assumptions for multiemployer plans to match those of single-employer plans. In addition, Congress should make the PBGC's multiemployer program more like its single-employer program, including a variable-rate premium and PBGC takeover when plans become insolvent.

Conclusion

In theory, defined benefit pension plans provide stable retirement incomes and pooled longevity insurance, but in practice, many defined benefit pensions can now provide only a small portion of what they have promised. This is because of the failed structure of defined benefit plans, including conflicting interests, the long delay between when benefits are promised and when they come due, and a lack of regulation requiring plans to fund their promised benefits properly.

Defined benefit pension failures will cause workers and their families to lose a significant portion of their earned retirement benefits and unjustly force taxpayers to finance the excessive retirement benefits promised to public-sector—and potentially even private-sector—workers. Congress, state and local politicians, and pension plan administrators should do all they can both to minimize pension losses on promises that have already been made and to shift workers out of unsustainable defined benefit pensions into defined contribution plans that will better serve savers and taxpayers alike.

*—**Rachel Greszler** is Senior Policy Analyst in Entitlement Economics in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom, at The Heritage Foundation.*