THE BROOKINGS INSTITUTION

PUBLIC PENSION REFORM:
QUESTIONS OF POLITICS AND POLICY

Washington, D.C.

Wednesday, February 26, 2014

Introduction:

MATT CHINGOS
Fellow
The Brookings Institution

Presentation of Findings:

PATRICK McGUINN
Associate Professor of Political Science
Drew University

PATTON PRIESTLEY MAHLER
University of Virginia

Keynote Address:

THE HONORABLE CHUCK REED
Mayor
City of San Jose, California

Moderator:

RUSS WHITEHURST
Senior Fellow and Director, Brown Center on Education Policy
The Brookings Institution

Panelists:

MARK DINGLEY
Deputy Treasurer
Rhode Island Office of the General Treasurer

THE HONORABLE CHUCK REED
Mayor
City of San Jose, California

PATRICK McGUINN
Associate Professor of Political Science
Drew University

PATTON PRIESTLEY MAHLER
University of Virginia

P R O C E E D I N G S

MR. CHINGOS: Good morning and welcome to Brookings. Thank you for braving the winter weather to be with us today. I'm Matt Chingos. I'm a fellow in the Brown Center on Education Policy here at Brookings.

Last May, my colleagues and I released a report calling attention to the nearly $3 trillion hole in public employment pension systems nationwide. That's the difference between the cost of the promises that have been made to employees and the amount of money set aside to cover those expenses. Since then the situation has worsened in several places. Most notable in the news these days is Detroit, where, in December, a federal judge ruled that the promises made to public employees for their retirement benefits were not sacrosanct as basically they had previously been held to be pretty much everywhere because that city is entering bankruptcy. And earlier this month, the major ratings agencies downgraded Puerto Rico's debt to junk status, in large part due to ballooning pension deficits and in spite of attempts to reform those systems and rein in rising costs.

Now, those are obviously extreme examples, but even more typical cases are unsettling. In the absence of new revenue sources, ballooning pension obligations are likely to crowd out other vital public services, such as education. One recent analysis found that in the Milwaukee public schools, the rising pension costs there will mean that without new revenues, between now and 2020; they'll have to either fire 24 percent of their teachers or reduce the salary and benefits of their teachers by 24 percent. So these are hard problems that present policymakers and voters with tough choices.

Today, the Brown Center has released two new reports that I think will help move this debate forward and we're lucky to be joined by their authors. Our first presenter is Patten Priestly Mahler, who's currently finishing her Ph.D. in economics at the University of Virginia. Her research focuses on the impact of pensions on teachers and schools. She's formerly a high school physics teacher, did her undergraduate degree in physics, and I think that's apt because it basically takes a degree in physics to understand some of these pension technical issues. Some of her research has been supported by the Center on Retirement Research, Boston College, and she's going to be joining the faculty at Center College in Kentucky this fall.

Patten will be followed by Patrick McGuinn, who's a professor of political science and education at Drew University, where he also chairs the Political Science Department. He's an author of numerous book, academic papers, and policy reports on a wide variety of topics in education policy and politics. He's a former social studies teacher at the high school level and also has his Ph.D. from the University of Virginia.

So with that, I'll turn it over to Patten and remind you to Tweet using the hashtag #pensionreform.

MS. MAHLER: Thanks, Matt. I hope that the discussion today stays away from my physics knowledge and just focuses on the economics.

Good morning. It's been my pleasure to work with Matt Chingos and Russ Whitehurst, and I'm delighted to be here sharing our findings from the report, "Improving Public Pensions: Balancing Competing Priorities."

So as Matt just described, public pensions are at a crossroads. Taxpayers urgently push to cut costs and reform the nature of public pension systems, while public sector workers value the current system that affords them the retirement security that they've always been promised. It's ultimately in the best interest of both taxpayers and the public sector workforce to make changes to many of these underfunded pension systems before they go broke, but it's difficult to agree on what those changes should be as it seems that these two groups have fundamentally competing interests.

We have two objectives in this report. First, we lay out a framework that can be used to revaluate proposed reforms. This includes three goals for a well-functioning system. Second, we propose a pension plan that meets these goals better than the current public sector plan or the popular alternative of a 401(k)-style private sector plan.

The point here is not to promote our proposed plan as a silver bullet reform, but rather to show that these seemingly competing interests of taxpayers and workers can be met simultaneously with an innovative hybrid type of plan. So before I get into the depth of the report, I'd like to talk briefly about the differences between current public sector plans, defined benefit plans, and private sector retirement plans called "defined contribution." Both require contributions and provide benefits, but the feature of the plan that is defined is what individuals are guaranteed.

A defined benefit plan has the guaranteed retirement benefits that come in the form of a set amount provided to an individual every year from retirement until death; so, for instance, $50,000 a year. The contribution amount from the worker and the employer may vary in order to achieve that benefit amount.

A defined contribution plan is the opposite. The contribution is guaranteed, but the total benefit is variable. So, for example, an employer puts $10,000 towards your retirement savings every year what you work. The total amount that these contributions grow to is your benefit amount, but it depends on how you invest this money as to what that benefit actually is.

So whether the $50,000 benefit or the $10,000 contribution is defined dramatically affects the plan's ability to meet our three proposed goals, which are providing adequate retirement savings, ensuring that the plan is fiscally sustainable, and maintaining or improving workforce productivity. First I'll discuss these differences and then I'll present this hybrid plan that we proposed, which lies somewhere in between these two plans and combines their strengths.

So starting with goal one, providing adequate retirement security. Individuals can fall victim to a number of risks that may prevent them from having a sufficient retirement nest egg. The most perilous risk is managing stock and bond market variability. A major difference between defined benefit and defined contribution plans is the way in which they protect individuals from this risk. So recall the $50,000 a year defined benefit plan. This amount is guaranteed regardless of any kind of market hiccups, so one caveat is that only very long-term employees are actually going to reap the full benefit of the defined benefit plan, but it does a good job protecting them from market risk.

On the other hand, defined contribution plans place individuals at risk of market fluctuations because the individual's responsible for figuring out what to do with that $10,000 a year. However, mid-career movers likely prefer a defined contribution plan as it's more portable.

Thus, with respect to our first goal of providing adequate retirement savings, defined benefit plans have a much better potential to reach this goal, but, again, only for full career employees.

Moving on to goal two, ensuring fiscal sustainability. We describe two pieces that are necessary to ensure fiscal sustainability. The first is government accountability. The second is a balance of taxpayer costs and benefits.

With respect to the first mechanism, government accountability, defined benefit plans have a fundamental issue: there's a long lag between the time an individual's promised his benefit and the time that he actually receives the $50,000 a year in retirement. This lag leaves room for pension plan providers to skip payments to the pension system and make errors about the projection of investment growth and benefit payouts, making it hard to hold governments accountable.

The second mechanism for fiscal sustainability is the balance of taxpayer costs and benefits. The cost of a defined benefit plan is not transparent, but rather complicated and uncertain. If pension investments fall short of guaranteeing the benefit amount, pension providers must make up the difference in cuts to other public services and/or increased taxes, and these likely upset the balance of taxpayer costs and benefits.

Defined contributions are more fiscally sustainable because they don't have these issues. Costs are immediately recognized and deposited into worker accounts, so that $10,000 a year, making government more naturally held accountable. And this cost is clear and unchanging with regard to market fluctuations.

The other side of the cost-benefit analysis is the benefits, so the receipt of high-quality public services. And this leads us to goal three, which is maintaining or improving the public sector workforce productivity. Defined benefit pensions have embedded incentives that kind of pull mid-career employees to stay in their jobs and push late-career workers out, as early as their mid-fifties. There are conditions under which these incentives actually make workers more productive, but the public sector does not necessarily have these conditions.

Defined contribution plans have no incentives to pull or push employees, but this is not necessarily a good time. It could actually increase costs in terms of additional turnover and higher retirement and payroll compensation.

At present, how retirement plans interact with workforce productivity is a relatively open question, so defined benefit and defined contributions don't necessarily perform either better or worse, but they definitely perform differently.

So at this point, I've described how defined benefit plans are superior in terms of providing adequate retirement security, but defined contribution plans are much more fiscally sustainable. They both have pros and cons in terms of their overall effective workforce productivity.

Now we turn to our hybrid plan called a collective defined contribution plan. And as stated earlier, this plan kind of lies somewhere in between a defined benefit and a defined contribution plan.

The hybrid gives an individual a specific account, just like a defined contribution plan, but the accounts are managed like a defined benefit plan. So workers are not entitled to a certain benefit amount, but they're much less exposed to market risk than a traditional defined contribution plan because they're managed jointly by professionals and kind of level market downturns.

The Center for American Progress has a comprehensive outline of a collective defined contribution plan called SAFE, standing for “Secure, Accessible, Flexible, and Efficient.” In this report from last August, the authors show that these market risk-mitigating mechanisms result in the SAFE plan having a much better likelihood of guaranteeing that individuals have adequate retirement savings, which is our goal number one.

From the point of view of the employer and the taxpayer, this hybrid functions just like a defined contribution plan. So workers and employers contribute money in real time, meaning no lag between promises and benefits and a more promising level of fiscal sustainability, which is our second goal.

With respect to the third goal of promoting workforce productivity, we propose a few tweaks to our hybrid plan to limit turnover and recruit additional workers. For instance, a nationwide public sector plan could attract mobile workers as it would be easy to move across jobs in different localities without penalty. We also suggest that policymakers consider changes to personnel practices together with pension reform in order to keep costs down and encourage productive workers to stay.

In conclusion, the actual pension reform enacted depends on interests of many powerful stakeholders. So our intention was to lay out three goals that stakeholders could work toward together and to give an example of a hybrid plan that has the potential to please public sector unions with adequate retirement security and also taxpayers with fiscal sustainability and high-quality public services.

A final imperative reform concern is how do we get there from here? In the report discussed next, Patrick McGuinn details a number of lessons and recommendations for achieving successful reform. Our hope is that the discussion provided in our report will move us toward at least one of his goals, avoiding making pension reform an ideological debate, and prompt a productive conversation where reform proposals can be evaluated and politically feasible policies can be tweaked and improved.

Thank you very much. I’ll turn things over to Patrick McGuinn for his remarks.

MR. McGUINN: Great. Well, thank you. It's great to be here today and I'd like to thank Brookings and, in particular, Russ Whitehurst and Matt Chingos for the invitation to do this paper, and also the people who agreed to be interviewed for this project who were so giving of their time and insights.

Ironically, when a group of scholars and practitioners first met at Brookings in October to discuss pension reform, it was the week of the federal government shutdown, which underscored the inability of the Feds to address the nation's major fiscal challenges. My paper on state pension reform is, fortunately, more optimistic. While the political barriers to pension reform are high, a number of states have enacted significant changes to their systems in recent years. My paper provides an overview of the political dynamics around pension reform nationwide as well as comparative case studies of reform efforts in four states.

Two of these states -- Utah and Rhode Island -- enacted significant structural changes to their pension systems. In 2010, Utah ended its traditional defined benefits plan for new workers and offered them instead a choice between a defined contribution 401(k)-style plan and a hybrid defined benefit/defined contribution plan. Rhode Island's 2011 pension reforms were among the first to change benefits for current workers and retirees by suspending COLAs and raising the retirement age. It also created a hybrid defined benefit/defined contribution in which all employees will get a diminished guaranteed pension supplemented by a defined contribution plan similar to a 401(k).

The two other case study states -- New Jersey and Illinois -- enacted more limited changes that resulted in cost savings, but were less innovative. Their reforms focused primarily on increasing employee contributions, raising the retirement age, and suspending COLAs in exchange for a state commitment to increase its annual payment into the pension system. While Illinois committed to making actuarially required payment in year one, the New Jersey reforms contained a seven-year ramp-up to the full payment. The long-term viability of the pension reforms in Rhode Island, New Jersey, and Illinois, however, remain uncertain due to the ongoing court challenges and concern about whether the states will make the pension payments that they have promised.

The case studies in the paper contain a great deal of detail -- 50+ pages of detail -- about the nature of the pension reform process in each state, the political dynamics that enabled reform to pass, and the specific changes that the four states made to their pension systems. I encourage you to read the paper for this detail, but given the brief nature of today's presentation I'll focus on synthesizing the key political insights that emerged for would-be reformers.

So, lessons and recommendations. First off, the nature of any particular state's public pension system challenges, as well as the political environment for reform, obviously varies widely. But several lessons and recommendations emerge from the 4 state case studies and from the 21 interviews with national experts and key players in the reform effort in each state that can guide policymakers in this work.

So, first, states should make their complete actuarial payment every year. Now, this is an obvious point, but nonetheless crucial. Making the actuarial payment is a necessary, if often not sufficient, condition for having a sustainable pension system. When payments are skipped or made only in part, the unfunded liability in the pension system can grow quickly, especially if the market goes down. There's a strong temptation, for political reasons, for legislators to look only at the short-term and make quick pension fixes that resolve that year's budget problem rather than address longer-term structural issues in the retirement system. Reformers should seek to make it a legal or even constitutional requirement that their state makes its full actuarial pension payment every year and that the State Retirement Board and legislature have to act if the pension fund gets severely underfunded. Public sector unions should be prepared and even empowered to sue in court to force the state to make its required payment when it fails to do so.

You need a credible and visible reform champion. Given the contentious nature of pension reform, the credibility, visibility, and skill of the messenger is very important. Senate President Sweeney in New Jersey, because of his history as a union leader, and Treasurer Raimondo in Rhode Island, because of her experience in the financial sector, were uniquely positioned and qualified to deliver the message of pension reform. This leadership may emerge from different places in some states: the effort has been led by the governor, while in others it was led by a legislative leader or even the treasurer. While pension reforms are supported by many Republicans, having a Democrat lead the effort goes a long way towards countering the charge that reforms are merely a conservative attack on labor. And in states where Democrats have large legislative majorities, such as Rhode Island, Illinois, and New Jersey, Democrat support for reform is, of course, a necessity.

Gather and disseminate the hard data. Would-be reformers need to start by collecting updated and unbiased information about the status of the pension fund and its projected future health. This data and a simple explanation of what it means can bring transparency and clarity to an opaque and confusing issue. Policymakers should request more accurate cost projections, using more realistic actuarial assumptions. These changes are likely to result in a larger unfunded liability than previously thought, creating a sense of urgency around reform. Treasurer Raimondo's work with the Actuarial Board in Rhode Island and the publication of her "Truth in Numbers" report is a great example of this. The report was written in an accessible style and widely disseminated, and framed the reform conversation in a clear and data-driven manner.

Communicate and educate. It can be difficult to convince the public and political leaders that pension problems that may not fully hit until many years in the future need to be addressed today, particularly when doing so requires political and financial pain. Reform advocates need to take the issue directly to the public by investing time and resources in implementing a multifaceted communication strategy utilizing social media, town halls, television, newspapers, radio, and mailings. New Jersey Senate President Sweeney, Utah Senator Lundquist, and Rhode Island Treasurer Raimondo devote a tremendous amount of time to convincing citizens around their state of the need for reform, often one small group at a time.

Avoid turning pension reform into an ideological issue, as Patten noted before. Reform leaders in successful states emphasize the need to run a positive campaign that does not seek to blame unions or make the issue ideologically charged, but rather lets the numbers drive the conversations about fiscal realities and budgetary tradeoffs. The unions may or may not endorse the financial pension reform bill, but it's important to give them a voice and an opportunity to participate in the process.

Teachers and other public employees feel targeted by pension reform and you have how demonstrate how pension cuts are part of a broader package of steps to address state budget problems that will reasonably and equitably distribute pain. Ultimately, it's about fairness.

Sell the benefits of pension reform to state workers and school reformers. Most of the debate about pension reform focuses on the negative financial impact of changes on retiree benefits. But pension reforms should be framed as ultimately in the best interest of pension participants relative to the consequences of the pension plans getting to the point where they can't meet their obligations.

In addition, recent research has demonstrated convincingly that the structure of compensation and benefits for teachers and other public employees has a major impact on labor market dynamics. And the traditional defined benefit systems impair states' abilities to recruit, retain, and deploy a high-quality workforce, making the case that pension reform is necessary not only for fiscal reasons, but also to improve the critical human capital in schools, is a powerful two-pronged argument.

Pension reformers should enlist the support of advocacy organizations that focus on school reform more broadly, such as Students First, 50CAN, and Stand for Children, as well as teacher voice organizations, such as Teach Plus and Educators for Excellence, which represent younger teachers who are disproportionately harmed by traditional pension systems.

Build a diverse coalition and a statewide advocacy campaign. Public sector unions have large memberships and extensive resources and typically deploy their political influence to oppose pension reform. In order to be successful reformers need to build a counterweight to the unions, a pro-reform coalition that can work to persuade policymakers and the general public of the need for pension changes. It can provide direction and communication across groups that are supportive of reform and direct resources at lobbying the legislature and public engagement. The group can also conduct surveys to demonstrate public concern about pension problems and support for particular reforms.

Ideally, the pro-reform coalition will be diverse and broad-based and include groups from across the political spectrum, not just conservative and business groups, but also social services groups who are concerned about how pension costs may affect their own state's spending priorities. This coalition can be led by a new single issue advocacy group, as in Rhode Island with Engage Rhode Island, or by an older group that has a broader agenda, as with the Civic Federation of Chicago in Illinois. Given the unions' threats of electoral retaliation to politicians who support pension reform it is also important the pro-reform groups promise to defend them and support them at election time, and then stick around to do so when the time comes.

And finally, anticipate legal challenges. The U.S. Constitution, along with many state constitutions, gives a high level of legal protection to contracts, and this has opened the door to court challenges to pension reforms in many states. The outcome of these cases depends on a state's specific statutory and constitutional language as well as the interpretation of the courts. But reformers can be strategic in designing reforms that can survive inevitable legal challenges.

So, in conclusion, there is an intense debate raging nationwide about constitutes an adequate pension for public sector workers, the kind of system that will best serve the interests of retirees and taxpayers -- a defined benefit, defined contribution, cash balance, or hybrid plan -- and whether changes in benefits to current, retired, or future workers are fair. This paper did not attempt to answer those questions or identify the one best pension reform, though it highlighted the different views on these issues that have emerged in state legislative deliberations about reform. There are legitimate concerns that recent changes and reductions in benefits will harm the quality of life of retired public workers.

However, this paper starts from the premise that the pension systems in many states have simply become unsustainable, and that significant changes are necessary to protect the retirement benefits promised to workers and to relieve the growing pressure on state budgets due to large, unfunded liabilities and increasing annual pension payments. If changes are not made, states will increasingly face the prospect of pension systems becoming insolvent or having to significantly reduce spending on other state priorities, such as education and healthcare. And this is why, by the way, in states very pro-labor, strongly Democratic states, like Rhode Island and New Jersey and Illinois, it’s actually been Democrats that have taken the lead in initiating pension reform.

While it’s, of course, possible to raise taxes to pay off pension obligations, this appears politically impossible in many states. And as the case of Illinois demonstrates, tax increases alone do not address the longer-term fiscal issues around pensions.

There’s also growing evidence that the structure of traditional public sector pension systems is ill-suited to attracting and retaining a high-quality workforce or permitting the kind of worker mobility necessary to better match worker skills and preferences with workplace demands.

A serious conversation about the nature of the pension challenge in American states is long overdue. And by highlighting how some states have been unable to enact reform, this paper hopes to advance that conversation.

Thank you. And with that, I’d like to introduce Russ Whitehurst, who’s the director of the Brown Center for Education Policy here at Brookings. Thank you.

MR. WHITEHURST: Well, thanks to the two presenters. And my role here is, and the project in general, as well as today, is to be somebody who, a few years ago, didn't know anything about any pension except his own and has been pulled into a circumstance where they're complicated issues and very wise people are involved with them and I'm trying to make sense of it all. And one of the things that I've learned from the work I've done here and the meeting we had with experts back in October is while most of the actions that can actually improve pension prospects occur at the state level. The pinch occurs first at the local level. It's the school district, the city, the municipality that is having to make contributions to the pension plan to support their employees, and they find that the cost of doing that has risen to a point where it has the strong likelihood of crowding out other essential public services.

So it comes down to a choice at the local level of doing nothing about the pension plan and having to close the parks or lay off police or have fewer teachers, or trying to address that problem. So it's the reality of the problem occurring first at the local level that makes it very important to have people who struggled with it at that level help us think through what the appropriate response should be.

And that's one reason we're very excited today to have with us Mayor Chuck Reed of San Jose, California. San Jose is the third largest city in California; the tenth largest city in the United States. It has a lot of public employees. And it found its pension costs more than tripling over a 10-year period, approaching 20 percent of the annual revenue of the city simply to pay pension benefits. Mayor Reed was the person on-point who had to deal with the political realities of this. And he has -- I'll try not to steal all his speech lines by describing what he's done, but he's been very active at the local level. Currently frustrated legally in moving to a system in which benefits can be renegotiated going forward, but not going backwards, and has taken this to the state level; with some other mayors is proposing a statewide ballot initiative in California that would give local entities, like San Jose, the right to renegotiate pension benefits.

So I look forward to hearing what Mayor Reed has to say today and his important contribution to this conversation. Please join me in welcoming the Honorable Chuck Reed. (Applause)

MR. REED: Thank you, Russ. Thanks for inviting me in to speak. And I want to thank Brookings in the aggregate for its interest in this topic. It's vitally important to the city of San Jose and many, many other jurisdictions around the country and I appreciate the third party review and commentary that helps us in the debate all over the country.

A little bit more about the city of San Jose. Russ described it a little bit. We're the capital of Silicon Valley, the innovation center of the world. Over the last couple of years, we have led the country in the rate of job creation. We have general obligation bond ratings AA+ and Aa1. We have two independent retirement plans that have earned since their inception in excess of 7.5 percent.

I'm a Democrat. My council is Democrat; we only have 2 Republicans out of 10 on the council. We're a Democratic city in a Democratic state. And so you might wonder what would motivate us to take on pension reform and put in front of the voters a ballot measure to reform pensions over the objections of our 11-unit bargaining units, and how it would be possible for the people to vote yes on a pension reform measure at 70 percent yes. And the short answer is the alternatives were worse. And when the pain gets so much, you're facing service delivery, insolvency, or bankruptcy, that's a big motivating factor to do something. And so I want to give you a little bit of background of why the pain was bad in San Jose.

If you look at the decade prior to us getting into the pension reform and fiscal reform effort, we had some general revenue increases, nothing to brag about, 19 percent increase in revenues over the decade. But our costs went up by 85 percent. Now, you know if your costs are going up faster than your revenues, you're in trouble. It's just a question of how long until it gets really bad.

And over that decade we coped with those rising costs by reducing our workforce. We ended up with 28 percent less people working for the city of San Jose than we had at the beginning of that decade. We went from basically 7,400 employees to 5,400 employees. Now, that meant we cut services in every part of the city. There's no department that escaped the cuts, no matter how high a priority they were. And we laid off firefighters, we laid off cops, we laid off librarians. We cut, cut, cut for a decade, and we were faced with continuing problems.

And so we got motivated, but, first, you have to figure out, well, what's causing the problem? We did the analysis on those cost increases and it was clear that the largest single factor in those cost increases which were driving the cuts were retirement cost increases. Now, that's both pension and retiree healthcare costs. So in that decade, we're talking about we went from a $73 million cost to a $245 million cost, and that translates to roughly 20 percent of our general fund spending, which how we pay for services.

And, of course, public safety is our number one priority. It's our core service. The Police Department's the most important department unless the fire chief is here. I don't see the fire chief. (Laughter) So definitely the Police Department's our most important department.

So how did that play out in the Police Department, our most important department, the highest priority? Over that decade, we increased the budget in the Police Department nearly $100 million. Why? Because it's our number one priority. But yet, we ended up with less employees at the end of that decade than we had at the beginning, and that's because the costs went up a lot, driven by skyrocketing retirement costs. So we ended up with 20 percent less people and a much larger budget. And other departments fared much worse. The Fire Department's roughly the same, but you can see that as costs go up, you have to do something, and that something was cutting services.

Now, just so you will not think that San Jose is an outlier in the state of California, the rate of increase that we experienced with our retirement costs was actually less than the average rate of increase experienced by most other plans in the state of

California. The aggregate taxpayer contributions into retirement plans and the pension systems went from $3.4 billion to $17.4 billion over a 10-year period. So San Jose, while we were rapidly increasing our costs, wasn't nearly as bad as some other places.

In California, of course, despite the fact that costs have gone up dramatically and we have contributed a lot of money, it's not over. California has huge unfunded liabilities. The governor's recent budget pegged them at $218 billion. CalPERS, which is the vast majority of agencies that are in the California Public Employees Retirement System, they've told their members to expect a 50 percent increase over the next 6 years. The teachers' plan, CalSTRS, has said they're going to be out of money in 30 years and the state needs to give them another 4- to $5 billion a year over 30 years to avoid running out of money in 30 years, meaning that teachers starting work today won't get a retirement. They'll pay in, of course, but they won't get one. There won't be enough money. So that is not a good circumstance.

Oh, and by the way, those are the optimistic scenarios. Those are the numbers that are based on basically a 7-1/2 percent rate of return calculation, which there's probably less than 50 percent probability of achieving those, so that's why I called them optimistic.

To add a little bit to the papers that have been presented this morning, I'll just talk about some of the things that we have learned. First, I would agree with Patrick McGuinn's assessment of the variables and the importance of all the factors that he's identified. It's really important to have third-party validation. Brookings is one of those independent third-party organizations that can have a lot to say about what we need to do at the local level and the state level. But there are two important objectives that have come out of our experience in San Jose and what we're trying to do.

The first is we want to make sure that our retirees and our employees get paid what they've earned. Bankruptcy is not something we want to do and go in and cut payments. That's what we're trying to avoid. We want to make sure that our employees get paid what they've earned. But, at the same time, we want to make sure our residents and taxpayers get reasonable services that they deserve.

Now, either one of those problems alone, eh, not that hard to fix. But trying to do both at the same time is what makes it extremely difficult. And the central problem in the entire equation is the fact that the benefits are too expensive. The costs are too expensive. And that's not something you can fix with actuarial assumptions. Benefits cost what the benefits cost, and they're too expensive. The government cannot afford to pay for them and the employees cannot afford to pay for them. So shifting the cost to employees, while that is a helpful step, it is only an interim step because it doesn't solve the cost problem.

And for significant reductions in costs you have to deal with the current employees. You can't just say, okay, for new employees we're going to do something. Well, that's good. It's important, but it doesn't solve the problem. It doesn't deal with the trillions of dollars of unfunded liabilities that we see at state and local governments because those are all related to current retirees and current employees. So you have to deal with the current employees, which is one of the things we did in San Jose.

The other thing I learned is the sooner you start, the better off you are. But the sooner you start, the harder it is to convince people you need to do something. But if you wait too long, bankruptcy's your only choice and we very much want to avoid that.

So what we did in San Jose, given those issues, is we provided a new tier benefit for new employees, a defined benefit plan, because we think retirement security's important and defined benefits are important in that area, but require the new employees to pay for half of the cost of the benefits, whether that's normal costs or unfunded liabilities or whatever. Half of the cost, so that they have an equal stake in controlling those costs.

More important, though, as I said, you have to deal with the current employees. So for our current employees we wanted to preserve the defined benefit plan, again, because retirement security is important, but we need our current employees to help us pay for unfunded liabilities. So we've provided in our ballot measure that current employees would have to pay additional, on top of what they're already paying, an additional 16 percent of pay to help go towards unfunded liabilities. Now, they can do that either in the form of paying more for the costs or taking pay cuts.

Sixteen percent, that's a lot, but our employees are already paying somewhere between 16 and 20 percent. So you add 16 percent on top of that and you can see that's very expensive; difficult for employees to pay that. So we gave our employees a choice. If you want to take a lower level of benefits that looks a lot like but is not exactly the same as our new employees, you get to keep what you've earned to date and go in at different accrual rates and a different retirement age for when you can receive the benefits and lower COLAs. Really there's not many things you can do. We did everything that we could and gave them a choice of going into lower accrual rates, later retirement age phased in, and lower COLAs. So that was the ballot measure.

So, where are we now? Well, we're over 20 percent of our general funds going into retirement costs. That's not good. The per employee cost for retirement benefits this year for public safety -- police and fire -- is about 97 percent of payroll. And the total cost for our non-public safety is about 73 percent of payroll. And our employees pay between 16 and 20 percent of those costs.

We have unfunded liabilities of about $3.7 billion. Now, I know in Washington, 3.7 billion isn't a big number, but it is for us. It's roughly about nine years of payroll to cover those unfunded liabilities.

But the ballot measure has helped. We're saving over $20 million this year. We'll save hundreds of millions of dollars over into billions over decades. But it's still in litigation. We have more savings that we hope to get when we get done with the litigation. We had seven Superior Court actions filed and six or seven actions with the Public Employees Retirement Board, an administrative agency. But even with the changes, our costs are going to continue to go up for another 10 years, according to the actuaries who work for the independent plans. So making employees pay more, well, it's helpful. It's an interim step. You have to do more than that.

What you really need to do is reduce the costs for current employees. Now, this is a common problem nationally, not just in San Jose or in California. We have what's called the California Rule on Vested Rights that makes change nearly impossible for current employees. That's followed by roughly a dozen states. Alicia Munnell from Boston College has done a lot of work in this area, so if you want to look at the legal analysis, I would refer to her paper. Nearly two-thirds of the states have some difficulty, some level of difficulty, at making changes for future benefits for current employees. So it is essentially impossible to implement a collective defined contribution plan for current employees in most states. That's something that needs to be changed.

So the question is how do we get from where we are today to be able to go to a collective defined contribution plan or any other version of reform? And there are two ways to make those changes.

The first, in dealing with the California rule, is to take the case to the California Supreme Court. The San Jose ballot measure cases, we now have a final decision from the trial court. A couple years from now we should be at the California Supreme Court and we'll give them a chance to say whether or not the extreme interpretations of their 50-, 60-year-old precedents is really what the Supreme Court intends to be the law in California, but that's a couple years off. But I think its important San Jose's got a case and there's a couple other cases that'll go up at roughly the same time from other areas that have done other reforms.

The second is to change the California Constitution. So I and a group of other mayors, we have five mayors -- four Democrats, one Republican -- that have signed on as proponents of a ballot initiative to change the California Constitution to allow cities, counties, local governments, and the state to negotiate changes for future benefits, for future years of services, and future contracts. People get to keep what they've earned, but the future should be negotiable around benefits, just like it's negotiable around wages.

Of course, you can already negotiate about benefits in the future, but you can only negotiate them in one direction and that's up. So we need to be able to negotiate them down. We need to be able to slow down accrual rates, maybe stretch out the retirement age, or change the COLAs. We need a constitutional amendment to do that. It allows people to keep what they've earned, protects what people earn as they earn it, but the future should be negotiable.

That ballot measure is still in the process. We have litigation pending against the attorney general of California over her inaccurate and misleading title and summary. That's set for a hearing March 14th in the Superior Court in Sacramento. It's unlikely we'll be able to get enough signatures in time to meet the schedule for the 2014 ballot, so it's more likely we'll be looking at the 2016 ballot.

So that's a couple of ways to change the California rule and ways to change it that could affect other states besides California. But back to the question.

Well, that's at least two years away. How do we get from here to there if we want to go to a collective defined contribution plan? And employee choice, it's really the only way under the vested rights doctrines to make changes for current employees is for them to do it voluntarily. Because under the vested rights doctrine those rights belong to the individual employee and unions can't start giving them away. They belong to the employees, but the employees can, by choice, choose to do something that would save them money and save the local government money. So we provided for that in the San Jose ballot measure. And there are many other jurisdictions that are doing that and have done that.

The difficulty is that how the tax treatment might be affected is unclear, and the IRS has not issued private letter rulings in this area since 2006. We put together a coalition of organizations. We have convinced the IRS it's something they should look at. It's on their work plan. In fact, it's been on their work plan for over a year. They just haven't done anything with it and they're reluctant to act and they've made no commitment as to when they will act and there are dozens of pending requests.

But employee choice is an important issue that provides some help in jurisdictions all over the country. It is a way to make some fundamental reforms, some structural reforms. Because if we don't make those fundamental or structural reforms, we'll have more cities, counties, other jurisdictions going into bankruptcy because if you can't deal with the skyrocketing costs of current employees you have two choices: cut services, raise taxes, or go into bankruptcy. That's not a very good menu. From a mayor's point of view that's a horrible menu, although we have certainly cut services and raised taxes. We're not going into bankruptcy because we're going to deal directly with the costs even though it may take a few years to do that.

Allowing employees choices is also something that has no cost to the U.S. Treasury. It could actually reduce cost to the U.S. Treasury. And it's also a way to deal with retirement security issues. The fundamental problem with defined benefit plans is they're high-risk and high-cost. And with the Vested Rights Rules as applied in California and other states, the day I hire an employee, I am stuck with 70 years of obligations based on assumptions that I make the day they're hired. And if the costs go up and the costs go up and the cost go up, extremely expensive and extremely risky to the local government. So as you see from the reforms that haven't been enacted around the country, it is highly likely that defined contribution plans are going to take over in the public system. No, maybe it won't happen quickly, but that's clearly the trend.

So those of us who believe that retirement security's important, that defined benefit plans have something to offer that we'd like to preserve for our public employees, having a choice so that you can reduce the costs is an important part of making those defined benefit plans a little more flexible and a little less risky for the government. Because if defined benefit plans can't be fixed, they will be changed. It's just a matter of how and where they go. And the collective defined contribution plan you heard about this morning is an excellent way for some jurisdictions to go.

And if you are stuck with a decision that's going to last you for 70 years, why would you ever want to take that risk? No government wants to do that. It's extremely risky, extremely costly, and your only way out is bankruptcy. That's a horrible situation and something needs to be changed and these employee choice provisions is a way to do that in the meantime, until the laws can be changed in the various states to allow negotiation about future benefits for future years of work in future contracts.

So that's where we're headed in San Jose and California. I look forward to the panel. Thank you again for inviting me in to Brookings. We always appreciate a chance to speak. (Applause)

MR. WHITEHURST: You've been introduced to everyone up here except the person immediately to my right. Mark Dingley is the deputy treasurer and special counsel for the Office of the Rhode Island General Treasurer. Rhode Island has been on the pointy end of the spear in terms of both experiencing a crisis connected with its public pension plan and the effort to deal with. Central Falls in Rhode Island was, I think, the first municipality to declare bankruptcy because it was unable to meet its pension benefits. And it really exposed a general problem in Rhode Island. It would have been the first domino of many to fall if something wasn't done about the situation.

Rhode Island just this past week got to the point of resolution with regard to negotiations for pension reform. And so I look forward to having Mark react not only to what we've all listened to previously, but also to share with us some of the insights from the effort in Rhode Island, which he's been a central player. Mark?

MR. DINGLEY: Thanks, Russ. To give some perspective, I think Rhode Island's smaller than San Jose, so it's not a large area. But, you know, one of the important things that I think that was discussed, maybe the most important thing this morning, was the emphasis that the mayor and both the presenters put on structural changes. I mean, just as an example, in Rhode Island, the state passed a law in 1992 that required the state to pay its ARC every year. And so in 1992, we were about 55 percent funded. We paid our ARC every single year until 2011. We went from 55 percent funded to 48 percent funded.

So how does a state pay their ARC every single year and still see a reduction in the funding of its plan? The way that happens is through various actuarial techniques. You can reamortize. What does reamortize do? It reduces your annual contribution. You can mark your assets to market, which means that you usually use five-year averaging, but if you're having a couple good years, you mark your assets up very high so that you get the advantage of high market. You know, you can raise your expected rate of return, which also reduces your contribution rate.

Rhode Island did all of those things. And so even though we were statutorily paying our ARC every single year, we saw our funding percentage go down over time.

And I think that's the importance of structural changes in both what Patten and Patrick and the mayor were emphasizing, which is with a defined benefit plan, defined benefit plans are very much subject to political influence. Okay? If you don't have enough money, let's reamortize. Let's mark to market. Let's raise our interest rate. And so those kind of things can always happen during difficult times. In Rhode Island those things happened. We weren't violating our statute. We were paying our ARC every single year. But because of the structure of a defined benefit plan and because defined benefit plans are subject to political pressure, it's very difficult to get ahead of the game in a defined benefit plan.

A lot of the states that have troubles don't even pay their ARC. If you look at Illinois or New Jersey, I don't think they've paid their ARC maybe ever. (Laughter) So that's an even deeper problem. But I think focusing on these from a structural perspective is important because you've got to look at whether or not, given the structure of defined benefit plans, governments can really ever get ahead of them realistically.

The other thing is my background is as a lawyer, so I always look at these things from a legal perspective. And I think every major pension change at the state or local level in the country has been challenged legally. So I think as a premise, when you're looking at this process and you're starting on a road down this process, you have to know what the legal precedents are in your jurisdiction and you have to see a path to get past those. The path in California is probably harder than it is anywhere else because of their constitutional and Supreme Court protections.

But the majority, if you look at the cases across the country, they say that if you make changes solely for budgetary reasons, you will lose. Because if you could breach a contract because you can't afford to pay it, then you could breach a contract any day. The government could breach any contract they wanted if the justification for that is they can't pay for it. So when you're establishing a legal track record, you need to establish a track record that the changes that you're making are structural changes that you're making for the long-term benefit of the state and for the long-term benefit of the participants in the plan.

One of the things I liked about Patten's paper was her emphasis on the impact of retirement plans on HR, human resources, workforce productivity. If you look at the demographics of the current workforce, I mean, when these plans were set up in the 1930s and '40s, many people worked a full career in one job. Defined benefit plans are good plans if you work a full career in one job. They're not a good plan if you're going to work 5 or 10 years in one job and then switch jobs. And if you look at the demographics of today's workforce, many people in the workforce change jobs on a regular basis.

Patten, what was your -- you had an average in yours.

MS. MAHLER: I said eight years.

MR. DINGLEY: Eight years, and that was for someone who started a job in their thirties, I think. So even at that stage, you're changing jobs regularly.

So one of the things we focused on in Rhode Island was what kind of plan did we need to address workforce productivity? I mean, that's not a pure budgetary issue. It's addressing, you know, what the workforce looks like, what you want your workforce to look like.

And as mentioned, I think, by both our presenters, you know, when your pension costs get really high, it impacts your entire workforce. And in Rhode Island, if we hadn't made changes, we would have been paying 35 percent of pay, going up very quickly to 45 percent of pay. Not quite like the mayor's numbers in California, but when you're spending 45 percent of salary for pension benefits, what that does is limits your ability to hire new people. It limits your ability to give promotions, give raises. Those are all things that very much impact different groups within your state workforce.

One of the not surprising, but one of the I think noteworthy elements of the Rhode Island reform was there were a lot of young teachers who were on board for the Rhode Island reform. These were young people who saw how bad the pension plan was. They didn't think it would necessarily be there for them in 30 or 40 years when they were at retirement age. And they also weren't committed to saying that they were going to work as a teacher for the next 30 or 40 years. Their idea was, well, maybe I'll work as a teacher for 5 or 10 years and then I'll go on and do something else. And so their defined benefit plan was not really answering. There was a 10-year vesting schedule in Rhode Island, so they wouldn't have even been vested in the defined benefit plan. And so when you're looking at these and building this in Rhode Island, we realized that we had to establish a legal foundation for our proposed changes.

The other thing we did is we didn't introduce legislation until the very end of the process. We came out; we looked at our actuarial assumptions. We did the "Truth in Numbers" paper. We put together a study commission that had public hearings for three or four months that explored all the issues. And it wasn't until the very end, and the end was a special session, that we introduced the legislation. That had a couple of effects.

Number one, as soon as you introduce legislation, it becomes an ideological battle. As soon as you introduce legislation, you draw the battle lines between management and labor, and that happens every time. Whereas if you don't introduce legislation and you have a dialogue and you talk about the various possibilities and so forth and you keep everybody at the table, you have a much better chance of not crossing that line.

The second thing, I think, where it really helped us, and by "helped us" I mean doing legislation last, was you got to put everything that you were ultimately going to do in the legislation on the table beforehand. So we had public meetings, public discussions. We talked about defined contribution plans, we talked about cash balance plans, we talked about virtually every alternative in the arena so that when we first introduced the legislation, we'd already put everything on the table. Nothing that we introduced in the legislation hadn't been already discussed at public meetings.

And then finally, having a special session I think is important. Because as I mentioned, from a legal perspective, if you're just looking at budgetary reasons, your reforms aren't going to succeed. And frequently, what happens with pension legislation is it's so volatile that it never passes to the end of the session. And the other thing that never passes to the end of the session is the budget. And the two things get mixed up with each other. And if you have a special session which is dedicated solely to pension reform -- and did they do that in Chicago as well or Illinois? I think they had a special session there. Then I think you have a better chance of dividing those things up. So that's a little bit of background.

In Rhode Island, where we eventually ended up is we went from a rich defined benefit pension plan to a -- we call it a combination system. It could be called a hybrid system. But we reduced defined benefit plans by approximately half and we introduced the defined contribution plan to make up the other half. And we did that, I think, for a couple reasons.

Number one, defined benefit plans were important in Rhode Island. They provide a lot of security, but it also goes to the risk question. And in my opinion, that's the real big question with retirement benefits. In a defined benefit plan, the employer, the state, the city maintains all the risk and in a defined contribution plan all of that risk is shifted to the employee. And so I think there's -- you know, a fundamental issue of fairness is do you shift all of that risk?

Now, what the collective defined contribution plan does is it shifts the risk to the employees, but it mitigates that risk by taking a lot of what I call the collective features of a defined benefit plan and sort of layering that on top of the defined contribution plan. But nevertheless, if it's a true defined contribution plan, even though you mitigate those risks, the risks continue to rest with the employee, the principal risks.

And in Rhode Island, we thought that it would be better to keep a defined benefit plan for a much smaller benefit and then put a defined contribution plan in place for the remainder of the benefits. By doing that, what we were able to show is if the defined benefit -- our investment return assumption in Rhode Island is 7-1/2 percent, so if our defined benefit plan provides its benefits and if our defined contribution plan, which is a 5 percent employee contribution and a 1 percent employer contribution, if that plan earns 6-1/2 percent, the benefits provided by that combination plan for a career employee are the same as the benefits that were previously provided under the defined benefit plan. So we split the risk, but we designed a plan for the benefits to be the same.

The other comment I'll make, this isn't the case in Rhode Island, but I think where you really need to think about keeping some defined benefit plan or design in place is many states don't have Social Security benefits for their employees. And where there is no sort of foundational benefit, I think it'd be very difficult to move to a complete defined contribution plan.

The big issue on defined contribution plans, once again, is risk, and we talked a little bit about this beforehand. And I think the question that everybody asks is, you know, if I've got a defined contribution plan I'm subject to market risks. Markets could go down significantly before I retire. If that's all on me, you know, how do I weather that? And, you know, if I want to have a defined contribution plan that's able to purchase annuities, unfortunately, when the markets go down, interest rates tend to go down as well because people are always jumping to bonds because they like the security. And so annuity purchases are much more expensive in those circumstances.

So I think the challenge for any defined contribution scenario is how do we protect against that risk? And I don't know if anybody on the panel wants to jump in and offer some ideas.

MR. WHITEHURST: Well, one of the things we discussed in the meeting we had before the public meeting is the possibility in a collective defined contribution plan of some averaging period, so that not only is the investment experience pooled, but the payout is pooled. So that if you have, you know, a great recession-type event, you're protected because of the rolling average that determines the payout each year. You're protected from some of the downside of that. Likewise, you give up some of the upside if you're retiring in a particularly good year.

So, you know, I think the devil certainly is in the details of these plans. And they're not going to go anywhere unless, first, the parties to the issue understand that they're between a rock and a hard place. Because as I look at reform efforts across the country, with a couple of exceptions, they've all been driven by dire prospects.

And then, you know, both Mark Dingley and Mayor Reed have referred, I think interestingly and importantly, to the need for choice. And so how you bring people into the process and have them choose something that has long-term viability, I think is about having something that also seems fair. And so you have to have a system that provides protection that seems reasonable in terms of prospects for retirement security given everything else that's available, and that can get people to the negotiating table.

I wondered if we as a panel could talk a little bit more about choice. You know, it's different at a legislative level, at the state level, than it is at the local or city level. When we had our private meeting here in October, we had another Mayor Reed, Mayor Reed of Atlanta, who was pursuing a course much like yours, and that is getting a voluntary agreement by public employees for a new path. How do you manage that? How do you get people to agree to something which, in the end, involves give-backs? Right? You have to agree to something that is different from what you have and that, at least on paper, seems less than what you have. How do you get public employees to agree to that?

MR. REED: Well, first, you have to be able to give them a choice and it has to be one that they can understand. So it's not a simple process, I don't think, because these are really complex issues. And so you start with a handicap of pensions are really complex and making a change makes it worse. But there are lots of employees who don't necessarily see them as staying with the city for a 30- or 40-year career. And certainly the younger ones are going to be more interested in choosing something different so that maybe have something that's more portable. The older and more closer you are to the retirement, the less likely you're going to choose whatever it is.

In San Jose and other jurisdictions, the costs are slowly being shifted to the employees, so the employees have an incentive to try to avoid those cost increases by taking, you know, a lesser costly and ultimately something different in the way of a the pension benefits. And I think it is that sharing of cost is the motivating factor for the employees. But the ability to have something when you're younger that's better for your age group and your prospects of staying is, also, I think, important.

So there's a generational difference in the viewpoint of these things. My younger employees understand and if they're riding up the elevator with me by themselves they will tell me they think I'm doing the right thing. Because they can see that when something is unsustainable, what that means is they're not going to get it. And the older, more experience employees are closer to retirement and they're less susceptible to making a choice.

MR. WHITEHURST: My -- I'm sorry, go ahead Mike.

MR. DINGLEY: Well, I was just going to say, part of it, Russ, I think goes back to what you said originally is that oftentimes people don't react until there's a crisis. In Rhode Island, Central Falls happened. And the pension benefits for the police, fire, and municipal employees in Central Falls were reduced by 55 percent. So people who -- and Central Falls is a very poor city, so people who were out there with a $25,000 a year pension saw their pensions reduced to 11-, $12,000 a year, and so that's a harsh reality. And that's a harsh reality that was felt by all the public employees in Rhode Island because saw that if it could happen to Central Falls, and there are other plans in Rhode

Island that are very poorly funded, people realize that it could happen to them. And particularly the younger employees looked at that and said if I'm teaching in a community or if I'm a police or fireman in this community and this could happen to me, aren't I better off with a defined contribution plan where that money's mine? The city can never touch it and I know that I'll get it when I retire.

So I think sometimes that movement toward a defined contribution scenario, unfortunately, will wait until a crisis happens.

MR. McGUINN: And I think maybe there's two other ways to build off the choice theme here, that choice is an important part of this reform conversation, not only to present workers with choices involved in retirement systems and their plans, but also to think about the political choices that have to be made, right, and the choices the taxpayers need to make. And I think, unfortunately, the political dynamics of pension systems right now is such that there's a lot of perverse incentives built into the system that encourages, right, permits and encourages even politicians to make the bad choices, right, that result in underfunding and systemic problems in the pension systems over time.

So when you think about how do we realign those incentives so that we encourage policymakers to make the right choices in that regard -- and part of that, I think, is, again, communicating with the public and really laying out -- the mayor's presentation here, you know, was very accessible. Here's the data, here are the numbers, here's the problem, and here are the options that we have on the table, and present those choices to citizens in really tangible ways. Right? So here's our budget shortfall. Here are the, you know, 10 steps that we could take, right, to change the shortfall. We could raise taxes by this amount. We could cut the number of teachers by this amount. We could cut police officers. We could cut firefighters. You know, we could cut benefits here. Here are the options. Right? And then really have an informed discussion about those choices to help support then the political choices that elected officials have to make.

MR. WHITEHURST: Seems to me as an observer of this area that one of the reasons many jurisdictions are in the pickle they're in is that the true cost of the pension promises have been hidden or obscured. Pat, I know you've written about this and our other panelists have information as well. I mean, how much -- one of the things that motivates my question is are we going to approach this issue piecemeal around the country, one city, one state at a time, when that city or state gets to the point of crisis and something has to be done? Or are we going to generate a political situation when people can look a little over the horizon and try to anticipate this problem and deal with it while it's still timely and easier to deal with than it will be before the crisis hits?

How much to do you think a standard accounting report that would be applied to every public pension around the country, that would allow an apples-to-apples comparison of the relationship between obligations and revenue would help in the public conversation?

MR. DINGLEY: Well, that's essentially what Moody's is doing or trying to do now. You know, the GASB Standards do it very loosely, but Moody's is doing a comparison and they are putting everybody on the same discount rate, they're putting everybody on the same amortization scheduled, and they're, you know, basically going to evaluate the creditworthiness of cities and towns on that basis. And so I think that, you know, that's -- I mean, when you get downgraded to junk bond status, that has a big impact on your community.

I mean, in Rhode Island's circumstances it doesn't just mean that you can only borrow very expensively. Sometimes it means you can't borrow money at all, and that's a really drastic circumstance for many municipalities. So I think there's going to be -- I think it's a sort of situation where it's going to be one-offs for a little while. And then I think -- my hope is that the management side and the labor side ultimately get together and come up with a solution that satisfies everybody, and I think that's possible.

At this point in time, I think the legal obstacles that the mayor's referenced, you know, certainly in the states where they have constitutional protection the labor side has so much of the law on their side that they don't want to give it up. So I think those are going be tough battlegrounds, but I think, ultimately, you'll see a shift because I think, and I don't know who said it, but the problem is going to be at the municipalities. You know, the most expensive plans and the ones that are in the biggest trouble are the police and fire plans because those are ones where people retire after 20 or 25 years, they're 45 or 50 years old, the contracts require they get pensions for the rest of their lives plus family healthcare for the rest of their lives, and those are just the kind of costs that our municipalities are not going to be able to withstand going forward.

MR. REED: I agree. I think the accounting standards and having some uniform rules is extraordinarily important because the key to getting the public support in San Jose with our 70 percent yes vote really was openness, transparency, sunshine, here are the numbers, here's what it's going to cost, here what it has cost, and since we have independent plans it was easier for us to do that. It's very hard for those who are in the CalPERS system, for example, to get that same kind of information and make it available to their residents and their taxpayers. But to build that public support, having a standard is really important.

We, in San Jose, are trying to fully fund our retiree health costs. We're almost there to full funding -- well, full amortization of the funding over 30 years is what we mean by "full funding." And we got started on that route because of the GASB -- Government Accounting Standard Board -- pushed us into recognizing we had a huge unfunded liability there. So driving people to face reality so that you can't kick the can down the road, well, you still can, but you have to admit it, that you're doing it, I think brings very important things to the debate.

MR. McGUINN: And I think, again, that transparency is crucial here and we haven't had that for so long and I think that has real political ramifications. It makes it much easier to push these issues under the table. And as Mark and the mayor mentioned, I think there's a role here for the national actuarial associations, for the federal agencies that deal with all this, particularly on the transparency side, they have less leverage than some of the other parts of this conversation, but it was interesting in New Jersey, it was the SEC actually that charged the state of New Jersey with fraud for the way it was misrepresenting the state of its pension funds and the investment returns that were associated with that. So, again, there's another action that existing agencies with existing authority can take both to push transparency and also to hold folks feet to the fire when they try to obfuscate around these issues.

MR. WHITEHURST: Let me give you a chance to interact with us and ask questions. Raise your hand, I'll call on you. You'll get a microphone. Please ask a question, make it short, and we'll move forward, and tell us who you are.

So the gentleman who's closest to the microphones here.

MR. GOLASH: My name is Mike Golash. I used to be -- I'm retired now -- I used to be a trustee of the Transit Employees Retirement Fund here in Washington, D.C., which covers 11-, 12,000 people, so I, obviously, have a sort of bias towards defined benefit plans.

First of all, I'd like to ask you have you looked at the history of some of these things? A lot of these benefits were negotiated over many, many years in which workers made various concessions in terms of wage increases or benefit reductions to get these plans, so that's a question of fairness.

Second is you noted that your actuary -- your normal costs were paid every year, but that's manipulative. Basically, the transit employees' actuary from 1997 to 2004 declared we didn't have to pay any normal costs because of the unusual returns that the stock market generated from the late '80s to the beginning of the 21st century. So all those years that the Transit Authority and a lot of local governments in this area didn't have to contribute anything, they never complained once about our benefits. But then when the stock market went down, they realized, hey, maybe that wasn't the best thing to do and now they're trying to shift those costs by cutting our benefits or increasing our contributions. There's too much disparity in wealth in this country that people on the top got to pay more to help these benefits survive. Thank you.

MR. WHITEHURST: We need a question. We need a question in there.

MR. DINGLEY: I mean, I would just say you're absolutely right. I mean, I think, you know, the position we took in Rhode Island is that employees have done nothing wrong. I mean, you know, we had very high contribution rates in Rhode Island, 8, 9 percent. They made their contributions every single year, you know. And a lot of it is, you know, as we've discussed already, the political process is such that there are too many techniques for people to avoid paying, for states and municipalities to avoid paying the real cost.

I think, you know, a demographic that you also have to look at is, yes, you're right, I'm in complete agreement, I'm a Democrat, there's too much wealth at the top, we've got to push it down. But in Rhode Island, the average public employee makes $54,000 a year. The average private sector employee makes $38,000 a year. So there's a real imbalance there in terms of the ability to tax more the private sector to pay these benefits when the private sector is making so much less on a salary basis, forget pension benefits.

And that shift has occurred across the country. If you look at the studies of compensation now, the public sector I think is equal or above in most jurisdictions the compensation levels of the private sector. So part of the struggle here is that other than that top 1 percent and the top group that I think you're referring to, you know, Main Street hasn't done well in the private sector.

MR. REED: I agree that most of these benefits were negotiated at the bargaining table and in the process that we use for setting compensation, but the simple truth is that we can't afford them however we got there. It's not the employees' fault; it's not the unions' fault. They're just doing their jobs. It's the elected officials' fault really is where the bulk of the blame goes. But nevertheless, no matter how you spread the blame, and there's plenty to go around, we can't afford the level of benefits that we're at now.

And the system is inherently unstable because there are the incentives to obscure the costs and to kick things into future generations. So in 1999, the state of California granted huge increases in retirement benefits to state employees and that trickled down to the local government in an infamous bill called SB 400. And at the time, the CalPERS system said we can do this. We can increase these benefits and it won't cost the taxpayers a dime, and that's a quote. Well, billions and billions of dollars later, it was quite a bit more than a dime and that's because people were saying, you know, hey, the '90s were great, the stock market's wonderful, it's going to keep going up forever. Well, we know that's not true. But at the time, all that was kind of obscured because everybody had money. But that was a huge mistake and we're living with it and we just can't continue to afford it.

Now, some places can afford it and they should pay. Everybody should pay their ARC, there's no doubt about that as being a critical factor. But ultimately, when you're paying more than 20 percent of your general fund and you're cutting police officers, firefighters, laying off librarians, you have to do something and that's what we were driven by in San Jose.

MR. WHITEHURST: A woman here with her hand up.

MS. MORRISSEY: I will try to make it quick and a question, but I guess my sort of meta comment is that this -- I was looking at the list of people interviewed for Patrick McGuinn's thing and there's 21 people there, of which I count one union representative and one other person of a sort of liberal-leaning think tank. Meanwhile, these reports were both funded by the Arnold Foundation which also funded the Rhode Island, you know, sort of pseudo grassroots group that said these things.

I am the author. I'm an economist at the Economic Policy Institute. My name is Monique Morrissey. I'm the author of the report. We wrote two reports on Rhode Island. We strongly disagreed with everything that's been said in here. You cite one of the reports. Nobody reached out to me or as, I don't believe, the author of the other report. And so I would like to -- you know, we disagreed with the "Truth in Numbers" report strongly, with the numbers in it, like the truth and the numbers aspect of it. And yet, I just want to make the point as to, you know, that I don't think that what's being represented here is in any way representative of both sides of the debate.

And I was wondering how you can justify taking money from an organization or a foundation that is funding a very distinctive point of view that's sort of taken over this debate and you don't even make a token effort to reach out to other people while talking about the importance of hearing the voice of unions or having token Democrats. And I understand that these are all Democrats, but there's a certain kind of -- you know, they're a Democrat that's very friendly to Wall Street. And I would say this, ultimately, is something that's being pushed by people who prefer defined contribution plans despite the fact that they're less cost-effective, that they shift a lot of risk unnecessarily on to workers, and why it is that there's not even really any real effort to reach out to the other side.

MR. McGUINN: Well, I can address the interview question, at least from the standpoint of my paper. If you actually review the interview list a little bit more closely, you'll see that, in fact, in each of the four case study states I tried to interview the union leaders in Utah, Illinois, and New Jersey. I did, in fact, interview union leaders there, listed there, and their perspectives are incorporated into the paper.

In the case of Rhode Island, I reached out several times, multiple times to the teachers union leadership in the state and they wouldn't return my calls and request for an interview. So I can request, but if they don't decide to speak with me, I can't speak with them.

MR. WHITEHURST: Front row here.

MR. RENAUD: Hi. Bryant Renaud. I work in the Tax Policy Center here. And I'm sorry if I missed this, but I was just a little curious about what potential role getting more of the state and local workers onto the national Social Security plan could play in some of these reforms.

One of the pension plans we're talking about -- firefighters, police -- they're the people who don't end up, in a lot of states, on Social Security. I think there's good reasons for that. You know, they have shorter careers, et cetera. But is there a role that Social Security, getting these people on it, could play in some of the reforms we're talking about?

MR. DINGLEY: Yeah. I mean, I think absolutely. I think, you know, we all worry about whether Social Security itself is going to survive because the way it's funded is a little tricky, but I think it's a good thing.

The challenge that we've seen out there is that it's expensive. You know, the employee contribution for the retirement benefits is 6.2 percent; the employer contribution is 6.2 percent, so you're talking about a 12.4 percent, you know, contribution right off the bat, and that's a big nut for a lot of municipalities and employees to swallow quickly. And so the question is -- you know, and, again, I think you've hit it on the nose with municipal police and fire -- is that's almost all collectively bargained and so you have to negotiate. So they're in existing plans. You can't just put this on top of that or the cost would be even more astronomical. So how do you somehow negotiate maybe a reduction in the current defined benefit plan with Social Security integration?

In the private sector Social Security integration used to be a very common way to fund private sector plans. It's not done as much anymore, but there's definitely models out there that could address that.

MR. REED: I think if I had my choice, which I don't, and was starting over, I would integrate Social Security into it. I think that could be a key component. And really, I would follow what is being done now for federal employees. You've got Social Security, you've a defined benefit, you've got a defined contribution, all sort of spreading the risk and bringing different elements to the equation. So it would be an important thing to do, I think, if you have a choice. And, again, we don't really have a choice in a lot of cases.

MR. WHITEHURST: And the federal government went from a system that did not include Social Security, didn't have the three legs, to a system that does, and so there is a model of how to get from here to there.

MR. DINGLEY: And I don't want to claim any lack of originality in Rhode Island, but our system is basically the federal system. We have Social Security; we have a defined contribution, and a defined benefit. And if you look at, you know the levels, they're pretty comparable.

I think we have a 1 percent annual accrual. I think the Feds have 1 percent and then if you work more than 20 years it's 1.1 percent. But we're very close to the federal model and that was part of how we sold the program. If it works for the federal government and it's sustainable for the federal government and it's a three-legged stool, shouldn't that also work for our state employees?

MR. WHITEHURST: Isn't it refreshing to be talking about the federal government as a model of how to do something? (Laughter)

Other question here?

MR. TURNER: I'm John Turner, Pension Policy Center. One of the contentious and important issues in valuing the liabilities is also a technical one, which is the choice of the discount rate and so I have a question. What was the discount rate or what is the discount rate that Moody's is using? Does it seem to be a standard perhaps?

MR. DINGLEY: I think Moody's is using an AA corporate bond rate or are they using the municipal -- let me think. They're using a rate that would reflect -- I think it's the municipal AA rate, okay, so the market rate that would be paid on a municipal AA bond. And the rationale for that is if the pension fund ran out of money, the cost of that money to the municipality would be its municipal bond rate. But, you know, the interesting thing about that -- and Patten's an economist so she would probably overrule me on this -- is that they always say when you look at discount rates you shouldn't use a tax-free rate, like a municipal rate, because your pension fund is already tax-free, so why would you take the lower penalty of a discounted municipal rate? But I think their rationale is that because the municipality would -- that's what they would have to pay to borrow money to supplant that. So I'm pretty sure it's a municipal AA rate that Moody's is using and it is whatever the market rate is in that particular year.

MR. WHITEHURST: And I would add, you know, there are two functions to a determination of the discount rate. One is to manage the local plan and so you need reasonable assumptions about what it's going to earn, but the other is to benchmark and make comparison. And so, in that sense, as long as the same rates apply to everybody --

MR. DINGLEY: That's right.

MR. WHITEHURST: -- it allows the mayor of San Jose to say, look, we're doing better or worse than San Francisco, and that's an important part of the political conversation.

MR. REED: I try to avoid the discussions and arguments about discount rates and assumed rates of return because it doesn't change the cost. It doesn't matter what the rate is, I'm going to have to pay the benefits. And the cost is the cost is the cost. And it's an interesting discussion and, of course, it affects contribution rates and everything. It's just a way to obscure the fact you're not putting enough money into the plan in most cases.

MR. DINGLEY: Yeah, the difficulty -- and I agree with you from a philosophic standpoint, but if you take a brand-new employee and throughout their career and you look at, you know, a contribution rate and earnings, earnings account for 80 percent of the savings for that benefit and only 20 percent is actually covered by contributions. So your earnings rate plays a wildly disproportionate role in determining whether you're going to have enough money. But you're right, your assumption means nothing. It's what you're actual earnings rate is that drives the day.

MR. WHITEHURST: Well, I thank you very much for being here today. Join me in thanking the panelists for contributing to, I think, a very interesting discussion. Thank you. (Applause)

* * * * *

CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

Carleton J. Anderson, III

(Signature and Seal on File)

Notary Public in and for the Commonwealth of Virginia

Commission No. 351998

Expires: November 30, 2016