

# DRAFT

Remarks of Keith Brainard

To the Little Hoover Commission

Chairman Hancock, members of the commission, thank you for the opportunity to testify before you today. I have been asked to focus my remarks on what other states are doing with respect to changes in pension benefits for public employees. First I would like to briefly elaborate on the broader issue of retirement security and the current condition of the nation's readiness for retirement.

A generation ago, in response chiefly to new federal laws and regulations, corporations began to abandon their traditional pension plans in lieu of defined contribution, or 401k, plans. In the mid-1970s, roughly half of the nation's private sector workforce had a traditional pension plan as their primary retirement benefit. Today, fewer than one-fifth of the private sector workforce is covered by a defined benefit plan, and that figure is likely to continue to decline. Defined contribution plans have replaced traditional pensions as the nation's predominant retirement benefit. Although defined contribution plans can be helpful vehicles for accumulating retirement savings, they have not proven to be effective at providing reliable retirement income.

I sometimes hear people say that if defined contribution plans are good enough for the private sector workforce, then public employees should have them too. This sentiment ignores two important facts: defined contribution plans as they are structured today lack features that are critical for fulfilling the central purpose of a retirement benefit; and that the reasons the private sector has migrated toward DC plans are largely irrelevant to the public sector.

Notably, barely one-half of the private sector workforce participates in an employer-sponsored retirement plan at all. Only two-thirds of the nation's private sector workforce works for an employer that provides a retirement benefit, and about one-fourth of those eligible elect to not participate.

The attention given recently to the problems associated with retirement benefits for employees of state and local government generally overlooks the larger and more important fact that our nation is facing a retirement crisis. Numerous studies demonstrate that most Americans approaching retirement age have saved far too little to replace an adequate portion of their working income. Studies also indicate that many Americans lack financial literacy, including an awareness of how much they will need to retire. This condition can be summed up concisely by quoting a Wall Street Journal editorial from just a couple of weeks ago:

The biggest, but most underreported, financial story in America is the looming retirement disaster. Eighty million baby boomers are approaching retirement, and most have absolutely no idea what's going to hit them. For them the financial crisis isn't over. It's just about to begin.

With that as a backdrop, I hope that California policymakers will evaluate possible changes to plan designs for public employees in the context of features that are known to promote financial security in retirement. I believe there is common ground among the stakeholders of public pensions, who are public employers, employees, and taxpayers. Each of these stakeholder groups has its own interests in the way public pension plans are designed and funded.

Some of these interests are shared by all of stakeholders, which creates the opportunity for common ground. Perhaps the most definitive common sentiment among the various stakeholders is that retirement security benefits everyone, which is to say that all of us benefit when others have retirement security.

Another belief many may share is that pensions work, which is true, when they are allowed to work. Pension plans have proven themselves to be an effective and efficient method for delivering retirement income. The problems associated with public pensions—chiefly their unfunded liabilities and the cost of amortizing them—are not a function of defined benefit plans per se, but rather are a result primarily of the way these plans have been designed and treated.

Public pension plans have several core elements that play a critical role in meeting the objectives of their stakeholders. These core elements include:

- Mandatory participation
- Cost-sharing between employees and employers
- Pooled assets invested by professionals
- Required annuitization of retirement benefits

An additional core element might be a plan design that replaces an adequate portion—however defined—of income in retirement.

I would encourage this commission and the state's policymakers to consider these factors as core and essential elements in a retirement plan design for public employees in California. It is possible to create a pension plan design and financing arrangement that accommodates the objectives of all stakeholders, using these core elements. A pension plan is not, by definition expensive; it just needs to be designed properly.

Although changes to public pension plan designs and financing arrangements have been occurring all along, the number and magnitude of changes being made to pension plan designs and financing arrangements for employees of state and local government around the country is unprecedented. At its core, a pension plan is a relatively simple financial entity: ultimately, the money that comes in must equal the money that goes out. Changes in pension plan designs and financial arrangements are simply a reshuffling of how much comes in, from whom, and when, and how much goes out, to whom and when.

Changes to retirement plans can affect new hires only, existing employees, existing retired members, or any combination of the three. My understanding of California's legal situation, however, is that changes to retirement benefits for existing plan participants and retirees would be legally difficult.

I would encourage the commission to remember that many state and local government employees in California do not participate in Social Security. This includes substantially all public school teachers and most firefighters and law enforcement personnel. As a result, the state and its political subdivisions are saving 6.2 percent of those employees' salaries, which saves well over \$1.5 billion for the state's public school districts alone. Another consequence of not participating in Social Security is that for many of those non-Social Security employees, their employer-sponsored pension will be their only source of reliable retirement income.

I have provided the commission with a grid that lays out some of what I believe are some of the more important and representative changes made recently to public pension plans in other states.

The most common changes affect new hires only, those hired as of some future date certain. Of course, some changes yield more savings than others, and some yield faster savings than others. Changes made to the required age at which an employee can retire and the required number of years of service often produce the most cost savings of available options. At least one dozen states have made such changes to

their retirement plan designs in the last couple of years. In almost every case, these changes have been applied to new hires only.

One exception is Rhode Island, which approved an increase in the normal retirement age from 60 to 62. Although this change affected existing plan participants, the changes were made proportionate to the participant's proximity to retirement, such that those who are close to retirement eligibility are affected less than those who are further away. Combined with other changes made by the Rhode Island legislature affecting the final average salary period and cost-of-living adjustments for future retirees (including existing plan participants), a group of unions representing public employees in Rhode Island has filed a lawsuit challenging the legality of the benefit reductions.

Several states have recently increased employee contributions. This includes New Mexico, which in 2009 reduced the employer contribution rate by 1.5 percent and increase employee contribution rates by the same amount. A lawsuit was filed by some public employee unions, but so far that legal challenge has not progressed in the state's court.

Earlier this year, legislatures in Colorado, Minnesota, and South Dakota took the unusual step of reducing automatic cost-of-living adjustments for existing retired members, along with other changes. Lawsuits have been filed in each state by retirees, and these legal challenges in each case are still pending.

A number of states have made other changes to their retirement plan provisions, that have smaller cost consequences. In some cases, the changes are targeted more toward preventing misuse of the pension fund, such as through spiking of pension benefits or poorly-designed return-to-work policies. It takes only a few instances of pension benefit misuse and abuse to tarnish the public's confidence in the integrity of these benefits. These plans are in place not to enrich anyone, but to serve as an income replacement vehicle in retirement. To preserve or restore both the financial integrity of these systems and the public's trust in them, pension plan provisions should be designed as much as possible to prevent misuse and abuse.

Pension policies have long-term impacts, and relatively minor changes can result in major cost savings in the future. I commend this commission for taking time to consider and evaluate such policies, rather than making a hasty recommendation.

That concludes my prepared remarks; I would be happy to answer your questions.