



States Increasingly Turn to 401Ks to Replace Pensions

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Big labor used the 43d anniversary yesterday of the assassination of Rev. Dr. [Martin Luther King](#) to hold hundreds of rallies nationwide, attacking “right-wing corporate politicians” for “trying to take away the rights Dr. King gave his life for: the freedom to bargain,” one flyer reads.

The demonstrators also blasted Wisconsin, Indiana and Ohio for trying to curtail collective bargaining rights and their public sector pensions. Demonstrators also said the states’ austerity moves could hurt the economic recovery.

But Barclays Capital says taxpayers are at risk of bailing out state workers if states don’t plug a \$2.4 trillion state pension deficit (including cities and towns). Other studies peg the deficit as veering towards \$3 trillion or more.

However, in a growing trend with sizable taxpayer impact, Utah, Alaska, Colorado, Georgia, Michigan, Ohio, and Kentucky are moving towards adopting 401(k)-type plans to replace pensions, says a top pension expert, Marcia Wagner. Last February, the [New York Times](#) had reported similar findings.

Moreover, the [Government Accountability Office](#) says states can legally make these changes, despite arguments that these plans have contractual restraints, Wagner notes.

The states’ moves comes as Moody’s Investors Services just this past January made a significant move by adding pensions to its risk factors for downgrading state bonds.

Prior to that, Moody’s did not consider pension obligations as bond debt. Like Standard & Poor’s and Fitch, Moody’s affixes credit ratings to bond debt—a lower grade can cause bond yields to spike, because governments need to offer more to investors to lure them in to riskier debt. In turn, that causes state borrowing costs to soar.

The Bureau of Labor Statistics reports the average annual wage for a state-government employee is now \$48,742, versus \$45,155 for a private sector worker. What’s more, the Bureau says the cost of benefits for state and local government workers has risen 50% more than those for private-sector employees since 2001. Colorado has the richest pensions, it typically replaces 90% of public sector retiree pay with pensions. New York’s public sector pension plans on average covers 77%.

Public sector workers in 41 states earn higher average pay and benefits than private workers in the same state, a [USA TODAY](#) analysis finds. In 2006, union wages in the private sector were about 19% higher than those in comparable nonunion firms, estimates economist Barry Hirsch of Georgia State University.

More money for pensions means less money for the poor, homeless, hospital care and cops and

firemen.

Meanwhile, 25 states last year faced public sector unions lobbying for tax increases on state taxpayers as well as spending hikes, says the National Taxpayers Union. The nonprofit watchdog group also found that 29 states raised taxes by \$24 billion last year, the largest sum since 1979.

Moody's Ranks the States Based on Pension and Bond Debt

Trouble is, only one of the states considering 401(k)s for workers—Kentucky—ranks tops on Moody's most at risk list of a downgrade due to total pension and overall debt.

Guess who is at the top? Think tropical. Think Hawaii—and Connecticut, Illinois, Massachusetts, Mississippi, New Jersey and Rhode Island.

Two states fighting for their fiscal lives also have massive bond and pension debts combined: Illinois, \$86.4 billion, and New Jersey, \$62.7 billion, according to Moody's data.

Nebraska and South Dakota rank at the bottom.

New York, Florida, Texas and California have high burdens, but not the largest combined burdens of pension and bond debt, Moody's says.

New York has \$50.8 billion, Florida \$38.4 billion, and Texas \$28 billion, Moody's says.

Moody's report lists California's combined debt as \$136.9 billion (\$87.3 billion bonds and \$49.6 billion unfunded pensions).

California's total bond and unfunded pension liabilities amounts to 162.6% of annual state revenue. The state's Democrat Governor Jerry Brown is trying to close a \$25 billion budget gap via "temporary" income tax hikes and spending cuts.

State's Gimmicky Pension Accounting

Moody's also noted in its report the controversial debate over the way public pension funds have underestimated their unfunded pension liabilities via gimmicky accounting.

The funds on average pegged an expected 7.75% rate of return, in order to offset or "discount" their future pension obligations.

That meant they set aside less in the pension pot, because they expected the markets to return more on their assets, so as to make up that difference. Some states have used 8%, others even 10%, something I said two years ago--on air and in this column--that Bernie Madoff couldn't get away with.

Another problem is, many states have tied pension payouts to earnings in the final year of service--so state officials discover lots of gallant overtime in a workers' final year.

The Problem With California

An unabashed blog posted by "Calpensions," which represents California pension funds Calpers and Calstrs—the state government and teachers pension funds—demurred that "economists argue that public pensions should use a lower discount rate based on 'risk-free' government bonds because the pensions are 'risk-free,' guaranteed by the taxpayer."

That's right—California's pensions are saying that they expect the state's overtaxed taxpayer to pony up once again, because these pension funds treat state residents like their own personal cash registers.

Note that no economists' names are cited here.

Like many other states, most of California's budget is monitored closely by unions, teachers and prison officials, who tend to treat the state capitol like their bank accounts.

California public sector unions are powerful enough to have blocked 2005 reforms from then Republican Governor [Arnold Schwarzenegger](#).

To this day California and many other states find government workers backload their public pay packages with added holidays and pension cushions.

Another Way

Utah, Alaska, Michigan and other states have devised their own, different ways of coping with the pension deficit issue, says Marcia Wagner, a pension plan expert, government advisor and ERISA lawyer.

Wagner says that some of the options states are looking at to help fix their pension budget problem include:

- Switching to 401(k) plans.
- Eliminating the ability to “spike” a pension at the end of one’s career by working more, switching to better pension-providing jobs, cashing in sick and vacation time, etc.
- Increasing mandatory employee contributions.
- Eliminating or reducing cost of living adjustments.
- Putting the investments out to bid in open and fair process.

Wagner notes that, while some of these states are being proactive in trying to find a way to fix their deficit, others refuse to switch to 401(k) plans and consider other alternatives, running the risk of running out of money very soon – as soon as just a couple of years.

States Moving to 401(k) Plans

A growing number of states are moving to 401(k) plans and away from fixed pensions for government workers, which are based on a formula related to employee compensation and service. The 401(k)-like portion could be modeled after the federal government’s Thrift Savings Plan.

A 401(k) plan is based on specified contributions into worker accounts.

Utah voted last year to make a partial changeover to a 401(k)-type plan, after the stock market plunge in 2008, which caused the shortfall in the state’s pension plan to balloon to \$6.5 billion, the New York Times says.

Utah followed several other states, including Alaska, Colorado, Georgia, Michigan and Ohio, which had chosen to offer a version of the plan, the New York Times reports.

In February, Kentucky’s Senate approved a full switch to a 401(k)-type plan, although the bill faces uncertain prospects in the House, the New York Times notes.

In Oklahoma and Kansas, state elected officials will be reviewing similar legislation over the next few weeks.

The new governors of Florida and lawmakers in North Dakota and Virginia are also seriously contemplating the adoption of 401(k)-type plans for state employees, Wagner says.

Opposition

Not surprisingly, public employee unions and their supporters favor pension plans, and until recently have been largely successful in retaining them through collective bargaining and pressure on the legislative process, Wagner says.

Attacks on pension plans were thwarted by unions and their allies in California in 2005, in Colorado in 2006, and in a number of states in 2007, Wagner notes.

“The unions would tell you that weaker public employee collective bargaining rights are associated with lower public employee compensation,” Wagner says, adding however that “there is recent research showing that there is not always a strong correlation between union rights and generous public pensions. High public pensions in nonunion Georgia are one example of this.”

Private sector workers routinely have to deal with new compensation rules, with changes typically made prospective and not affecting benefits already accrued, Wagner says.

Social Security a Problem?

One complication of just replacing pensions with 401(k)-type plans for new government employees is that many state and local workers aren't part of Social Security. They weren't included when Social Security was created in 1935; while growing numbers have been brought into the system, about a third still don't participate.

Part of the problem with applying a 401(k) system to existing public employees is that many may not have enough time to build up adequate retirement savings after the switch, Wagner says. Ensuring that this group has enough on which to retire appears to remain a priority, Wagner notes.

State Pensions Not a Contractual Matter

States can change the laws with ease, Wagner says, because state constitutions typically contain rules pertaining only to the funding of pension plans, and the investment and protection of assets within a public pension plan.

Much rarer are constitutional provisions that guarantee pension rights as a contractual matter, Wagner notes. There are perhaps eight or nine states in this category, Wagner says.

GAO Says States Can Legally Make the Change

Wagner points out that a 2007 Government Accountability Office study notes that “Legal protections usually apply to benefits for existing workers or benefits that have already accrued; thus state and local governments generally can change the benefits for new hires by creating a series of new tiers or plans that apply to employees hired only after the date of the change.”

Wagner notes that, if a state constitution only protects accrued benefits, a state legislature would be in the same position as a private employer and could make change with respect to future accruals, even for existing employees.

In light of the fact that legal restrictions are generally lacking, the matter of changing from a pension plan to a 401(k) plan seems to be a matter of political will, Wagner says.

However, as recent events have shown, the desire for change may have reached the tipping point, Wagner notes.

Upside to State 401(k)s

Workers own their retirement accounts and can carry it to another job.

They also benefit because politicians can no longer raid from state pension plans to pay for other government spending.

As for taxpayers, the reform could dramatically cut state pension liabilities and they no longer bear the brunt of being forced to pay higher taxes to cover state pensions, even if the stock market declines.