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Even with reform, R.I. outlook alarming

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T FALLS CHURCH, Va. he heated debate over how to fix Rhode Island's pension system — with votes in the General Assembly scheduled for today — begins with a basic question: Just how big are public-sector pension promises?

According to the state's numbers, Rhode Island is facing a daunting $9.3 billion in unfunded liabilities, and there is no money set aside to pay for them. Unfortunately, like all public-sector plans in the country, the picture is actually much worse. Rhode Island's unfunded pension liabilities are nearly twice that size, closer to $18 billion — and that's on the lower end of estimates.

Rhode Island, like many other state and local governments, misses the mark on calculating its pension liabilities because they are being valued as though they are risky bets instead of a government-guaranteed benefit.

This miscalculation comes from poor government accounting rules that let actuaries value pension liabilities on the basis of what pension assets are expected to return when invested in the market. These rules have led pension plans across the country to skip on pension payments, shift assets into riskier investments, and grant generous benefit enhancements. And that means Rhode Island, like many governments, has been setting aside too little money to fund future promises.

A public-sector pension is supposed to be safe because it is protected by state statutes and constitutions. These pensions are a government-guaranteed promise made to retirees, in the same way that the government promises to pay its bondholders. Defaulting on these promises is very unlikely and would have major repercussions. Considering this similarity, states should then use the lower Treasury rate to value their pension promises.

Since 1997, Rhode Island has assumed an expected rate of return of 8.25 percent on its pension assets, recently lowered to 7.5 percent. Unfortunately, assuming a certain rate of return on assets doesn't mean you will get that rate of return. The actual market returns for the state plans over the last decade were 2.28 percent. In the case of local plans, the average five-year rate of return was only 1.97 percent. Further, investment returns do not change what is owed. When you take a loan out from the bank to pay your mortgage, the bank doesn't lower your mortgage payment based on how well your 401(k) performs each year.

Currently, the bill to Rhode Island taxpayers for local plans and the Municipal Employees Retirement System stands at $2.4 billion, but it swells to $6 billion when valuing the public pension liabilities using the safer Treasury rate, and it jumps from $6.8 billion to $12 billion for state plans.

Such a jump is certain to place immense strain on Rhode Island's municipal governments, and Central Falls may not be the only local government to be pushed to the brink. Current unfunded municipal-pension liabilities exceed municipal revenues by $2.6 billion.

Fortunately, Governor Chafee's attempt to tackle this problem for state employees with proposed legislation puts Rhode Island ahead of many other states. The proposed hybrid plan would require state workers to contribute 8.75 percent of their paychecks toward retirement, of which 3.75 percent would be put toward a defined-benefit plan and 5 percent would be invested in the retirees' personal accounts. This would plug the hole in the current defined-benefit system, enabling the government to focus on increasing funding levels and protecting already accrued benefits. Importantly, the new plan shifts the risk away from taxpayers and also provides workers with more mobility with their retirement savings.

The proposal to suspend the cost of living adjustment benefit, although controversial, would cut the size of the state's pension liability in half, thus greatly increasing the system's funding levels. If the COLAs are suspended, current retirees will still receive their accrued benefits but will not receive an additional COLA benefit until the pension system is 70 percent funded.

While these all sound like drastic measures, the problem is far deeper than is currently recognized. Even with these reforms, locally operated plans are still in deep trouble, and local policy makers will need to follow the state's lead by phasing out their defined-benefit plans.

However, the key to stabilizing Rhode Island's finances is the same: Real pension reform must begin with an accurate estimate of the bill. The question is not whether the reforms being considered are reasonable, but whether they will be enough to solve the problem.

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