PIONEER INSTITUTE
PUBLIC POLICY RESEARCH

POLICY BRIEF

Myths and Reality about MBTA Pensions

by Iliya Atanasov

For the past few years, officials from the Massachusetts Bay Transportation Authority (MBTA) and the MBTA Retirement Fund (MBTARF) have promoted the narrative that the T's pension system has been reformed so that benefits are "fair" and it holds no risk for taxpayers.

The truth is that MBTA pension reform has been too little too late; more radical measures are needed in order to ensure that current MBTA employees' pensions will be there when they retire.

The purpose of this policy brief is to debunk the misconceptions around pension reform at the T and map out a simple, legal and fair path for change.

All comparisons hereafter are based on the pension rules for the most recent cohorts of MBTA and state employees, who started working after 6 December and 2 April 2012, respectively. Specifically, the comparison is between the MBTA Retirement Plan (MBTARP), the T's largest pension plan with an unfunded liability of $726 million as of yearend 2011, and Group 1 (Option A, where applicable) under the state retirement system, which is the largest group of Massachusetts employees with diverse job requirements eligible for a uniformly determined public pension.

Myth 1: MBTA pensions are commensurate with other Massachusetts public employees'

Contrary to the myth, MBTA employees receive much higher allowances per year of pensionable service than other public employees. At the T, effective provisions to prevent spiking (short-term raises or cashing in unused vacation days that would dramatically increase pension benefits with about the same level of overall contributions) have simply not been implemented. Under the current pension contract, MBTARP retirees receive a

> membership service allowance equal to 2.46 percent of the average compensation in those three (3) years in which the employee had maximum compensation, multiplied by the number of years of membership service…[1]

Furthermore, they can accumulate unused vacation pay and apply it toward final compensation,[2] which can also be topped off with

> any back pay or retroactive payments resulting from negotiated increases

Iliya Atanasov is Pioneer's Senior Fellow on Finance, leading the research tracks on pension portfolio management, infrastructure and municipal performance. Iliya is a PhD candidate in Political Science and Government and MA candidate in Statistics as well as a former Presidential Fellow at Rice University. He also holds BAs in Business Administration, Economics and Political Science/International Relations from the American University in Bulgaria.

Center for Better Government

February 2014

> [which] shall be counted as Compensation for the Member's final year regardless of whether such payments are received more than 2½ months after the Member's severance from employment.[3]

In contrast, state employees' pensions are determined on a five-year basis for those beginning after the most recent round of benefit reforms; in the state retirement system, most spiking loopholes such as using vacation days to augment final salary have been closed.[4] Only state employees retiring around age 67 can reach the service allowance rate of MBTARP, where a pension can start at the same allowance rate 12 years earlier at age 55 (see below).

To illustrate the impact of the service allowance rate, consider an employee retiring at age 60 with 30 years creditable service and earning $60,000 annually in the five highest-paid years of service, with a life expectancy of 25 more years.[5] In such circumstances, an MBTA and a state employee would have the same average pensionable pay of $60,000. If the retiree had worked for the MBTA, however, the pension would be 51.4% higher than that of a state employee (Fig. 1). Adding insult to injury, the MBTA retiree would receive a Social Security benefit as well; a former state employee would not be eligible for one unless it was earned in the private sector. Furthermore, even if the state employee gets a Social Security allowance, it can be reduced substantially by federal law because of the state pension.

The MBTA employee would also be in a position to spike the pension allowance significantly. A 20% pay increase in the last year of employment (for a total of $72,000) would result in a 7% increase in lifetime allowances for an MBTA employee, versus just 4% for a state employee. A 50% pay spike would increase the MBTA pension by 17%, adding $184,500 in pension allowances over 25 years; that pension would be over 60% higher than a similarly spiked state pension because the average pensionable pay for the state employee would be determined over five years rather than just three.

Even without the spike during the pensionable years, the MBTA employee could expect to collect some $375,750 more in pension allowances than a state employee with the same work record. With the 50% pay spike in the final year, the difference in total pension allowances jumps to about half a million dollars. To reiterate, these discrepancies do not reflect the fact that the MBTARP retiree would also be collecting an allowance from Social Security. Nor do they account for the fact that state employees contribute up to 11% of pay to their retirement system,[7] compared with just 5.5% of pay for MBTARP members in fiscal 2013 (a peak rate for at least a decade). Importantly, the MBTA employee can induce the spike and the higher pension just by saving up unused vacation – without any raise or promotion.

Myth 2: Early retirement handouts have been eliminated

The T's much higher service allowance rate and easier to manipulate average pensionable salary base[8] are only the tip of the iceberg. One of the motivations for MBTA pension "reform" was the notorious "23 and out" rule, whereby T employees could retire after just 23 years of service without penalty to their service allowance rate. Massachusetts taxpayers are largely unaware that this misguided practice was replaced with a similar provision, which grants a full pension as early as age 55 after just 25 years of service.

Fig. 1. Comparison of MBTARP and Group 1 State Employee Pensions

	Annual Benefit			Total Benefit/Cost		
	No Spike	Spike 20%	Spike 50%	No Spike	Spike 20%	Spike 50%
State	$29,250	$30,420	$32,175	$731,250	$760,500	$804,375
MBTA	$44,280	$47,232	$51,660	$1,107,000	$1,180,800	$1,291,500
Difference	51.4%	55.3%	60.6%	$375,750	$420,300	$487,125

Fig. 2. MBTARP Pensions at Age 55 with an Average Pensionable Salary of $60,000

	25-Year Service	35-Year Service
Allowance	$36,900	$45,000
Added Cost of Early Retirement	$184,500	$225,000

Simple arithmetic shows that meeting these minimum requirements qualifies an MBTA employee for 61.5% of the average pensionable salary, which is not far from the contractual cap of 75%. Thus, an MBTA employee with a pensionable salary base of $60,000 would get a pension of $36,900 (Fig. 2) under the minimum conditions for what the pension agreement calls "early normal retirement."

Raising the early normal retirement age to 60 would save an estimated $184,500 per employee retiring with the minimum service. The savings would be $258,000 for each employee choosing early retirement at a pensionable salary of $60,000 (assuming no further service) with service near the maximum possible under this option. When multiplied by 6,000 potential early retirees, these numbers add up to between $1.1 and $1.35 billion in nominal exposure.

Raising MBTARP's early normal retirement age from 55 to 60 would reduce potential liability exposure by an estimated $1.1 to $1.35 billion.

MBTARP's early normal retirement option compares unfavorably with the nearest available state-employee retirement option. Consider an employee with an average pensionable compensation of $60,000 under both systems, a life expectancy of 85 and 30 years of creditable service by age 55. If the employee stopped working and started getting a pension as soon as the plan would allow, a T employee would collect an annual allowance over 50% higher than his or her state counterpart's (Fig. 3). Because the state retiree would also have to wait until age 60 to start receiving the annuity, the MBTARP member would get nearly $600,000 more through age 85.

The discrepancy is particularly stark with 25 years of service. The MBTA employee can still start collecting $36,900 at age 55, nearly 70% more than the state retiree would be eligible for at least five years later. In this case, the MBTARP member will collect more than twice as much in retirement allowances through age 85 as the state system member.

As Figure 3 shows, the gap closes with more years of service, which drives home the point that the T still offers strong incentives to work fewer years, ultimately making the benefits more costly as they have to be paid over a longer period. The spread in plan cost would be substantially larger if one accounted for the smaller contributions that MBTARP members make towards their benefit.

Fig. 3. Select Pensions under Earliest Retirement Option Possible

	30 Years of Service		25 Years of Service	
	Pension	Total Cost	Pension	Total Cost
State	$29,250	$731,250	$21,750	$543,750
MBTA	$44,280	$1,328,400	$36,900	$1,107,000
Dollar Difference	$15,030	$597,150	$15,150	$563,250
Percent Difference	51.4%	81.7%	69.7%	103.6%

Myth 3: Taxpayers are protected from what happens with the MBTA Retirement Fund

That taxpayers cannot be harmed by mismanagement at the MBTA's pension systems is perhaps the most egregious myth of all. It has been used to justify the lack of state oversight of MBTARF over its 65-year history and as an excuse to turn a blind eye to the lavish early retirement options retained by MBTARP members.

According to the current MBTARP pension agreement, the T and, by extension, taxpayers will be paying towards the system's unfunded liabilities for as long as there are active MBTA employees in the plan. The only way to sever this link is by freezing the plan – either through a new union contract or an MBTA bankruptcy. Specifically, the current pension agreement stipulates that

> adjustments in Member contribution rates (effective on and after July 1, 2007) shall be based on the change from the total required contribution rate established by the December 31, 2004 actuarial valuation and applied to the Members' Required Contribution established by the December 31, 2004 actuarial valuation.[9]

In other words, if the total required contribution is 50% higher in 2013 than in 2005, the employee contribution must increase at the same rate. Taxpayers have to pick up the difference.[10] According to MBTARF's only published annual report, the T and employees had to contribute at a ratio of about 3.65:1 in 2012.

Most recently, it was discovered that the T's pension system lost $25 million it invested in a hedge fund recommended by MBTARF's former executive director. This potentially fraudulent loss remained hidden from the public for at least two years. To gauge the cost of the loss to taxpayers, it is necessary to amortize the resulting unfunded liability using the 30-year level-dollar method at an 8% rate of return, as last employed for MBTARP's funding schedule.[11]

Assuming 30-year duration, the liability requires 30 yearend payments of $2,220,686 each. Thus, the nominal dollar amount of annual contributions needed to offset the loss is $66,620,575. The 2012 pension contribution ratio between the MBTA and its employees implies that the T will have to chip in 78% of the payments – a total of $52,293,570 over the 30-year duration of the liability.

> The recently exposed $25 million hedge fund loss that MBTARF had been hiding for at least two years may cost the MBTA an estimated $52 million in pension contributions.

The same estimate can be calculated for the overall unfunded liability of $726 million, which was reported as of yearend 2011. Using the level-dollar method, it would require that the MBTA – in other words, the state and local taxes and subsidies that support it – contribute more than $50 million annually over 30 years to amortize the unfunded liability completely. Thus, instead of costing taxpayers nothing, MBTARF's 2011 unfunded liability may cost them an estimated $1.5 billion – provided that the generous assumption of 8% annual returns actually pans out.

> MBTARF's 2011 unfunded liability may cost taxpayers $1.5 billion.

Myth 4: Benefits for existing employees cannot be altered

Employee benefit reforms at the T and throughout the public sector have been stifled by the legal red herring that the terms for existing employees cannot be modified and they have to be protected from any changes to the system. This both obviates the bulk of the potential savings and creates two classes of employees – one privileged and another that picks up the tab by paying more to get less.

Even if the courts did indicate that an employee must retire under the terms available at hiring, workers can be terminated subject to a new agreement with the

union. Workers who agree to become members of the state system can be rehired; the rest can collect their benefits from the old MBTA retirement plans when they reach retirement. The vast majority of government employees who are not close to retirement would likely prefer to stay on.

To accelerate the elimination of the old system, continuing employees may also be asked to transfer the actuarial equivalent of their earned benefit to the new system, depending on the policy goals and the options available under the incumbent plan. In the case of MBTARF, such an option may not be available without changing the terms of the trust, which would, at a minimum, require the consent of the union effectively holding two of the veto seats on the fund's board.

Reality: Swift action must be taken to salvage MBTA pensions.

With or without union and MBTARF cooperation, however, state leaders should move quickly to restore sanity to the MBTA's pension plans in the wake of the recent revelations of alleged conflicts of interest, mismanagement and fraud.

Real MBTA pension reform must achieve:

A. Transfer of MBTA employees to a more reliable and accountable retirement system that is not controlled by MBTA and union insiders.

B. Bring MBTA pensions in line with the pensions of state employees.

C. No longer hold Massachusetts taxpayers liable for the backroom dealings of the "private" MBTARF.

D. Ensure 23-and-out and similar past pension handouts are curtailed in a legal fashion.

Here are some specific recommendations to reach these objectives.

First, state leaders must do short-term damage control, which does not require complex legislation:

1. State leaders must ask all MBTARF board members representing the MBTA and their alternates to resign effective immediately. The new appointees must be completely unaffiliated with the T and be selected with an explicit task to block all board decisions until all other board members, Executive Director Michael Mulhern and Deputy Director John Barry have been replaced.
2. The newly reconstituted board should have a clear mandate to appoint an MBTARF executive director with appropriate finance and/or actuarial experience who is unaffiliated with the MBTA to oversee the winding-down of the system.
3. The legislature should consider bill H.3118, sponsored by Rep. Gerald Parisella (D - Beverly) and Rep. Denise Andrews (D - Orange), which directs the Secretary of Administration and Finance to study the operation and performance of MBTARF relative to similar systems. This analysis should be conducted in close cooperation with the investigation of the fund recently announced by the attorney general.
4. The new MBTARF board should review the contracts of all current external contractors, transferring their functions to the Public Employee Retirement Administration Commission (PERAC), as appropriate. PERAC should immediately commence a full audit and actuarial valuation of MBTARF after these new functions are authorized by law.

Second, in cooperation with the Amalgamated Transit Union Local 589, which represents the T's unionized employees, the state should develop a transition program for transferring employees from MBTARP to the state system. The current pension agreement expires on 30 June 2014, which is an excellent opportunity for such a timely negotiation. To ensure the transparency and impartiality of the process, the state should:

5. Transfer bargaining authority to a panel unaffiliated with the MBTA composed of equal numbers of representatives of the governor, the House and the Senate, none of whom should be elected officials.

The government negotiators should have a singular and unwavering goal:

6. All (non-police) MBTA employees earning pension benefits under the new contract should do so as Group 1 employees in the state retirement system (cf. Myth 4); earned benefits under MBTARP can remain, but the plan will be frozen and receive no more payments from the T. (Nonunion employees can be required to transfer to the state system as a condition for their continued employment after 30 June 2014.)

Third, House, Senate and executive leaders should advance legislation transitioning MBTA employees to the state system and winding down MBTARF and the MBTA's retirement plans:

7. All MBTA employees hired after or who are not vested by the cutoff date can become Group 1 members of the state retirement system. Unvested employees' retirement accounts can be transferred from MBTARF to the state system (cf. Myth 1 and 2).
8. All other MBTA retirement plans can be frozen as of the cutoff date. MBTA Police Association Plan (MBTAPAP) members can become members of the state retirement system in Group 4 (mostly public safety employees who receive an enhanced pension). Unvested MBTAPAP retirement accounts can be transferred to the state system (cf. Myth 1).
9. The MBTA should be legally prohibited from making any contributions to any retirement system but the state's after the cutoff date with an explicit ban on further contributions to MBTARF (cf. Myth 3).

Finally, conditional upon cooperation by the union, the state should create options to maintain equity for MBTARP members who are retired or have substantial savings locked in MBTARF, which will be likely to go bankrupt after unvested members withdraw their funds and the T stops propping it up with fresh contributions:

10. Active MBTARF members may choose to withdraw the actuarial equivalent of their accounts and transfer it to the state system, where they will receive a benefit under the state system's new Group 1 rules.
11. Retired members may choose to withdraw the actuarial equivalent of their accounts and transfer it to the state system, where they will receive a benefit under the state system's rules, but they must pay for reinstatement transfer (restore all received benefits with interest up to a hypothetical retirement date in the past allowed under the Group 1 rules and refund the difference between the MBTARP pension and the Group 1 pension with interest).

While the last two steps are not necessary to save money and reform the system, they will protect the benefits of poorer retirees and recoup some of the more egregious handouts, which cannot be legally revoked, by accelerating the insolvency of MBTARF. Their implementation would most likely necessitate changing the trust's charter, which in turn would require the union's consent and strong leadership from elected officials.

Endnotes

1. Art. IV(1)(b)(1) of the Pension Agreement in MBTA Retirement Fund. "2012 Annual Report." https://www.mbtarf.com/sites/default/files/AR%20Final%202012%20A.pdf, accessed 2013.10.31, pp. 47-61.
2. Art. I(12)(ii)
3. Art. I(12).
4. 2011 St. 176.
5. Survivor benefit options are ignored throughout for simplicity.
6. The MBTA and its employees are not exempt from Social Security deductions on their payrolls, while the state and its employees are.
7. 9% on all pay and 2% on the amount above $30,000 annually.
8. The benefit for state employees is calculated over the five best-paid consecutive years, while MBTARP's over just three.
9. Art. V(1)(a).
10. Art. V(2)(a).
11. For a detailed explanation of amortization projections, see Atanasov, Iliya. "The Costs of Delaying the Funding of Public Pensions in Massachusetts." *Pioneer Institute White Paper* No. 109, forthcoming.

PIONEER INSTITUTE
PUBLIC POLICY RESEARCH

185 Devonshire Street, Suite 1101, Boston, MA 02110
T: 617.723.2277 I F: 617.723.1880
www.pioneerinstitute.org