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In Puerto Rico, Teachers' Pension Fund Works Like a Ponzi Scheme

By MARY WILLIAMS WALSH MARCH 8, 2017

The teachers' pension fund in Puerto Rico looks very much like a legalized Ponzi scheme — one that might hold a warning for teachers across America.

Puerto Rico, where the money to pay teachers' pensions is expected to run out next year, has become a particularly extreme example of a problem facing states including Illinois, New Jersey and Pennsylvania: As teachers' pension costs keep rising, young teachers are being squeezed — sometimes hard. One study found that more than three-fourths of all American teachers hired at age 25 will end up paying more into pension plans than they ever get back.

"I think they're really being taken advantage of," said Richard W. Johnson of the Urban Institute, a co-author of the research. "What's so tragic about this is, often the new hires aren't aware that they're getting such a bad deal."

The problem is magnified by the fact that the Puerto Rico teachers union — like many teachers and police unions around the country — opted out of Social Security long ago, hoping it could save both workers and the government money by not paying Social Security taxes.

That decision was predicated on the assurance that the workers' pensions would

Pension funds are supposed to be giant, largely self-sustaining pools of money, contributed by taxpayers and often workers, that earn investment income. Over time, the money is supposed to grow enough to pay retirees. Knowing this, teachers might reasonably expect to get a pension worth more than what they invested. But that is not always the case.

In Puerto Rico, for instance, the pension funds are so short of cash that money contributed by working teachers basically flows straight out to retirees. None of Puerto Rico's current teachers can expect to get their money back, because the fund is due to run out of money in 2018, long before they retire.

That is, essentially, a Ponzi scheme. But this structure is legal in Puerto Rico because of a complicated series of changes in the law brought about in recent years by the island's financial crisis.

Puerto Rico, a United States territory, ran off the rails by using debt to spend beyond its means. Year after year, the government could not balance the budget and borrowed instead, building up a debt of more than $70 billion. Last year it defaulted, and the federal government stepped in, trying to restore fiscal order and bring about a giant debt restructuring.

Pensions will be part of that restructuring. Puerto Rico also owes retired public workers more than $40 billion that it has no immediate way of paying; more than $13 billion of that is owed to retired teachers. Last week, Gov. Ricardo Rosselló of Puerto Rico called for giving current teachers a new, separate retirement plan, to spare them from having to help pay what the government owes its retirees.

"It's not fair to the current employees to make them pay for benefits the government itself should be paying for," said Andrew Biggs, a member of Puerto Rico's federal oversight board and a resident scholar at the American Enterprise Institute, a research organization.

The problem is urgent for both the governor and the island's federal oversight board — but it may be of interest to teachers elsewhere, too. Their plans have been retired. Some plans felt flush enough in the bull market of the 1990s to increase benefits, only to see the money melt away in the dot-com rout and the crash of 2008. Even longevity gains in life expectancy, normally a cause for rejoicing, are contributing to the pension woes.

To help cover the costs, most teachers' plans redistribute money between the generations, with many young teachers paying for benefits they did not agree to and will never receive themselves.

The plans are designed that way. Each state runs a big teachers' pension system, and some large cities like New York and Chicago operate their own. Public school teachers are usually required to participate, and they must almost always contribute part of their pay.

The benefits are typically backloaded. This means that teachers build up their benefits very slowly in their early years — even as they make big contributions — then speed up in middle age and earn the biggest part just before they retire.

But because of high turnover and other factors, relatively few teachers reach the sweet spot where they earn a pension larger than their contributions. Most change jobs or move away first, leaving behind money that subsidizes the pensions of the relative few who teach for decades.

Some analysts say it is appropriate to reward the longest-serving teachers, since they can have the greatest impact on students.

But lately, the hidden transfers from young to old have become more pronounced as pension systems have come under stress, and states take steps to cut costs. State laws often make it hard to change pension plans for public workers already on the payroll, so many cost-cutting measures affect only those hired after enactment.

The effects can be harsh. In Illinois, for example, Mr. Johnson of the Urban Institute found that a teacher hired at age 25 who worked for 35 years could earn a hired after 2011, the same teacher would earn a pension worth only $609,000, even though both groups contribute 8.4 percent of every paycheck.

"Over all, 84 percent of all newly hired teachers lose money" in Illinois, Mr. Johnson said.

In Cleveland, the public schools dodged insolvency in 2012 by making newly hired teachers pay the full cost of their own pensions — and help cover investment losses incurred years before they were hired, according to a 2013 study by Robert Costrell and Larry Maloney for the Thomas B. Fordham Institute, a research group focused on education.

"This is an extraordinary situation," they wrote.

Sandi Jacobs of EducationCounsel, a consulting firm, cited eight states that recently doubled — to 10 years — the time a teacher must work before vesting, or earning a nonforfeitable right to a pension. That is more than three times the maximum allowed for companies.

Delaware, Hawaii, Illinois, Maryland, New York, North Carolina, Pennsylvania and West Virginia all switched to 10-year vesting, Ms. Jacobs said, knowing that three of every 10 new teachers will quit in five years or less. Ten-year vesting lets them receive more contributions without a corresponding obligation to pay pensions.

"It's the easiest way to have an effect on their balance sheets," said Ms. Jacobs, whose findings were published last month by the National Council on Teacher Quality.

Martin F. Lueken of EdChoice, formerly the Friedman Foundation for Educational Choice, looked at the largest school districts in each state and found three where, because of cost-cutting, newer teachers might work their whole careers without ever earning a pension worth the value of their contributions: Boston, Chicago and the northern suburbs of Minneapolis.

right," Mr. Lueken said.

The new education secretary, Betsy DeVos, declined through a spokesman to comment on these findings. But the issue has surfaced this year in her home state, Michigan, touching on one of her favorite causes, charter schools. In Michigan, for-profit charter schools do not participate in the state-run teachers' pension system, which has a $25 billion shortfall.

Policy makers looking for ways to plug the hole want to make for-profit charter schools join the pension system, but opponents say it would be unfair to make them help pay off a $25 billion debt they did not create.

In Puerto Rico, every time a teacher is paid, about a tenth of that money goes into a pension fund that is burning through cash so fast there will be none left by 2018, according to a projection in a new 10-year fiscal plan issued by Governor Rosselló.

Puerto Rico has more than 42,000 retired teachers, including dozens over 100 years old, who are collectively entitled to about $55 million a month — and even more as more teachers retire. When the money leaves the pension fund to pay them, the government cannot afford to replenish it, so it uses the current teachers' money.

"I'm working, and I'm paying for the retirees," said Juliana Soto, 27, a public school social worker in San Juan. "Teachers may not know this, because they don't want to know. But it's not a secret."

An ill-starred pension law that was passed in 2013 put the biggest burden on the newest teachers, whose required contributions will soon rise to 14 percent of every paycheck.

It raised all teachers' retirement ages and replaced their traditional pension plan with a cash-balance plan — a type that eliminates backloading. That meant younger teachers would start building up their benefits faster, but middle-aged teachers saw the biggest part of their benefit snatched away, just as they were about

The Supreme Court of Puerto Rico agreed and rejected the changes — except as they would affect teachers hired after August 2014. That left veteran teachers earning the backloaded benefits of the old plan, and new hires paying the higher contribution rates of the new one.

Federal oversight may soon change that. In his 10-year fiscal plan, Mr. Rosselló has called for shifting all current teachers into a separate defined-contribution plan, where their money could no longer be used to pay retirees. Teachers who prefer the backloaded plan may well sue again, citing their win in 2014, but now that Puerto Rico is under federal oversight, federal law presumably trumps local precedent.

Mr. Rosselló has also called for helping workers to join Social Security where possible.

For current retirees, the federal oversight board had asked for 10 percent pension cuts, but the governor said on Wednesday that he would limit cuts to 3 percent, imposed only on retirees with pensions above $24,000 a year.

"This administration is committed to protecting the most vulnerable people," Mr. Rosselló said to enthusiastic applause in the island's imposing seaside Capitol. The seven-member federal board has until mid-March to decide whether to accept the governor's 10-year plan or impose its own.

The process is being watched closely in the states with troubled pension systems. Puerto Rico cannot declare bankruptcy, because of its status as a United States territory, so last year Congress enacted a special new law, called Promesa, which gives it a legal framework for restructuring.

The states cannot declare bankruptcy either, and experts want to see whether Puerto Rico's case shows how financially troubled states like Illinois can rebalance the interests of their taxpayers, investors, public workers and retirees.

But the disclosures provided by pension funds make it hard to see how much pensions cost and who pays — and that is no accident.

and their costs. "They could put this in their reports, but they don't, because their job is not to bring visibility."

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