

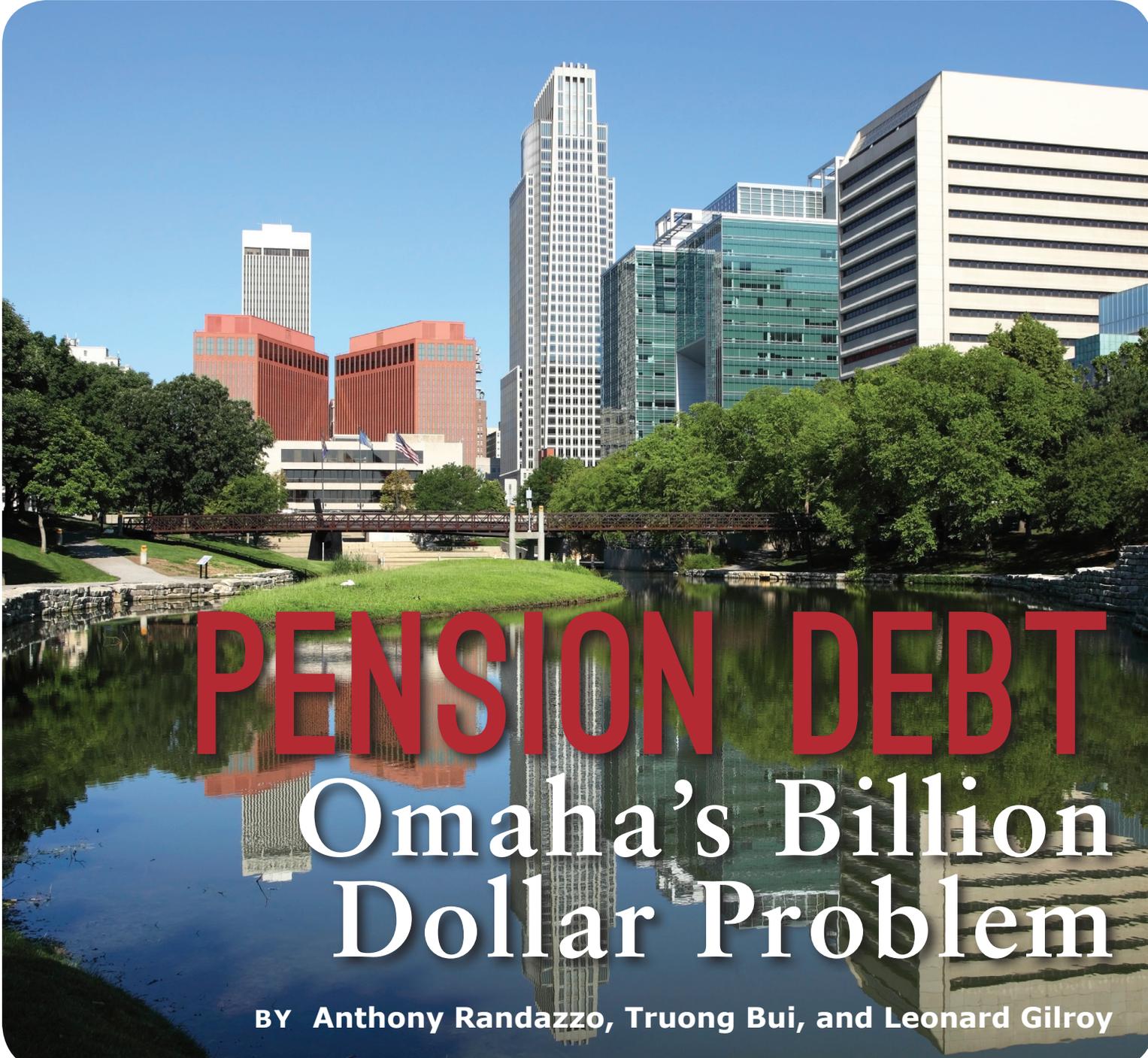
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PENSION DEBT

Omaha's Billion Dollar Problem

BY Anthony Randazzo, Truong Bui, and Leonard Gilroy

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PENSION DEBT

Omaha's Billion Dollar Problem

Executive Summary

The city of Omaha pension system's two plans are currently facing four problematic trends:

1. Pension Benefit Promises are Growing Faster than Pension Assets
2. Omaha Has Been Systematically Underfunding Its Pension Systems
3. Pension Debt Has Nearly Tripled Over the Last 10 Years
4. Pension Costs are Consuming More and More Taxpayer Resources

This brief discusses how these trends have been caused by poor actuarial assumptions and irresponsible public policy decisions. Omaha is using an unrealistic assumed rate of return on its investments, and is inappropriately depending on savings from the recently adopted deferred retirement option plan for current employees.

The only real way to reform Omaha's public employee pension plans is to adopt a new system that is not wholly reliant on the speculative forecasts of financial risk professionals.

It is often said that those who do not learn from history are doomed to repeat it. This maxim does not bode well for the City of Omaha Employees' Retirement System (Civilian System) and the City of Omaha Police & Fire Retirement System (Public Safety System). The history of these systems is one of four problematic trends fostered by two irresponsible behaviors: inaccurate actuarial assumptions and irresponsible pension fund management. And it is not clear that the right lessons have yet been learned.

This policy brief discusses those four problematic trends and explores possible solutions that would secure the future of Omaha's two public employee retirement systems. These trends are not new—studies from the Platte Institute have highlighted growing unfunded liabilities in Omaha for several years.¹ But the trends are getting worse, and each year they are ignored adds to the bill taxpayers will ultimately have to cover for poorly managed retirement benefits.

Four Problematic Trends in Omaha

1. Pension Benefit Promises are Growing Faster than Pension Assets

Retirement systems, like the pension plans in Omaha, are supposed to be fully funded in actuarial terms at any given time. Put simply, the value of assets in a pension fund *plus* the expected investment earnings should *equal* the expected value of all pension benefits promised to workers—these are known as liabilities.² Having a good measure of pension liabilities is important for determining whether the current value of assets, plus expected investment earnings on that money, will be sufficient to pay all of the promised benefits.

Unfortunately, Omaha's pension liabilities—the promised benefits—have been growing at a faster rate than the assets in the pension fund. Between 2004 and 2013, the liabilities for the Public Safety System grew 78.1%, but the

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assets grew just 29.7%. For the Civilian System, liabilities grew 31.5% over the last decade, while assets actually *declined* by 5.5%.

When liabilities are greater than assets, a pension system has “unfunded liabilities.” Figure 1 shows the growth in unfunded liabilities for each system over the last decade.

2. Omaha Has Been Systematically Underfunding Its Pension Systems

There are two primary components to properly funding a pension system.

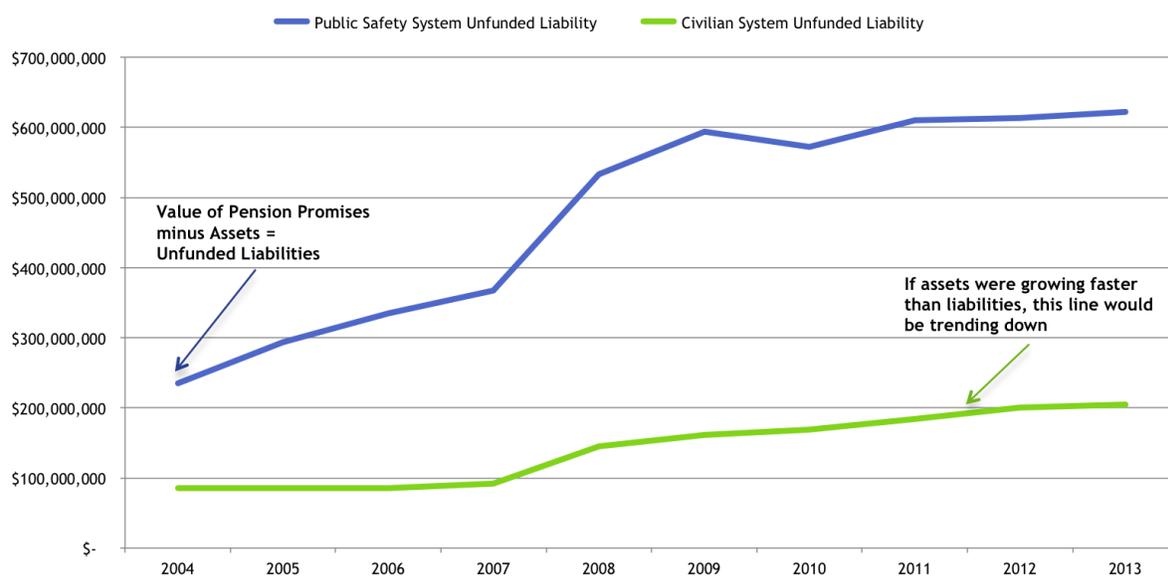
First, it is important to save enough so that promised pension benefits can be paid when workers retire. Each year financial risk professionals—known as actuaries—estimate how much will be needed in the future to provide the benefits earned by city workers during that fiscal year.³ To determine how much should be contributed by the city and employees that year to make sure there is enough money to pay for those benefits when they become due, the actuaries estimate how much the pension fund will earn through investing those contributions, what inflation will be, and how long retirees will live, among other things. The amount determined to be the necessary contribution for the current year is known as *normal cost*.

Second, where previous city and employee contributions and investment returns have failed to cover the benefits promised by the pension fund, there is an unfunded liability or *pension debt*. This debt must be addressed through a separate component of the annual pension contribution, which is known as the *debt payment*. Each year actuaries calculate how much tax revenue should be paid into the pension system in order to make sure the accrued debt gets paid off according to a predetermined schedule. The process is very similar to paying off student debt in regular installments.

The combined total of the two components—normal costs and the debt payment—is known as the “annual required contribution” (ARC). But even though this has the word “required” in the name, the city does not *legally* have to pay the full amount. The ARC is a recommended best practice for funding a pension system, but policymakers may consider other priorities or competing uses of taxpayer dollars. However, unless a system is already more than fully funded, any payment that is less than 100% of the ARC will result in the growth of unfunded liabilities.

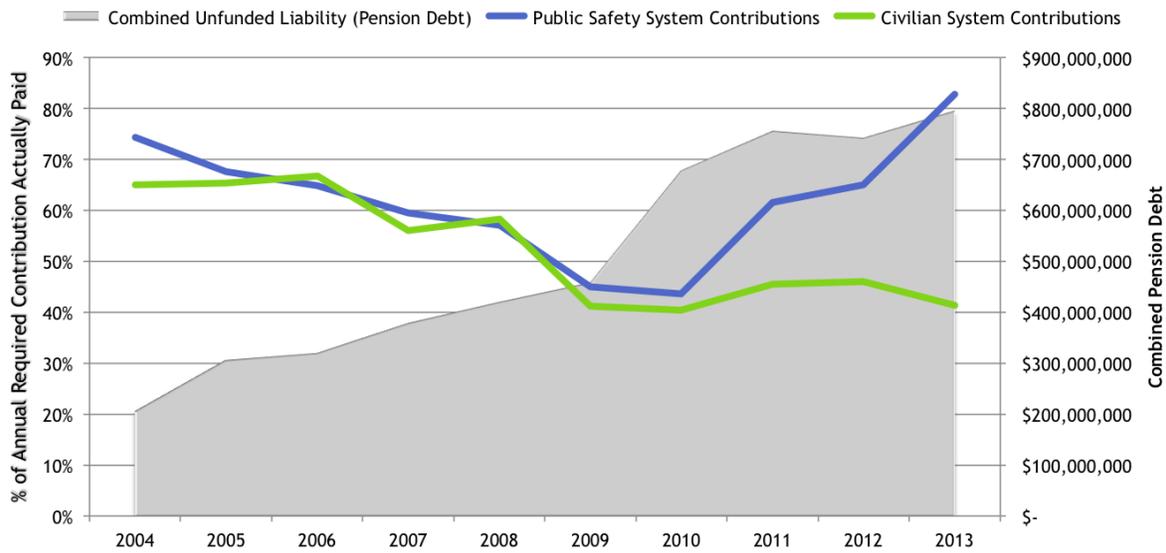
Unfortunately, Omaha's city leaders have failed to pay the full ARC every year over the past decade—in essence deciding not to fully fund future pension benefits. In fact, between 2004 and 2013 Omaha missed a total of \$219

Figure 1. Unfunded Liabilities for Omaha's Pension Systems, 2004–2013



Source: Reason Foundation. Note: Authors' calculations based on data from Police & Fire Retirement System (PFRS) and Employees' Retirement System (ERS) valuations.

Figure 2. Actual Contributions to Omaha Pension Systems as a Percentage of the ARC, Shown with Pension Debt Rising



Source: Reason Foundation. Note: Authors' calculations based on data from PFRS and ERS valuations.

million in required contributions—money that should have been in the pension fund assets earning returns.

Figure 2 shows that in 2004, Omaha paid 74.3% of the Public Safety System's ARC and 65.0% of the Civilian System's ARC. That amounted to underfunding promised pensions by \$8.2 million in that year alone. The situation deteriorated over the next six years, and by 2010, Omaha was paying just 42.9% of the combined ARC for the two systems—underfunding pension funds by \$39.7 million in that year. The following year, Omaha began to reverse the trend and increase contributions, but only for the Public Safety System. Last year, Omaha paid 82.9% of the annual pension bill for the Public Safety system, but only 41.33% of the ARC for the Civilian System.⁴ In short, over the past decade, Omaha city leaders have systematically underfunded the two systems, creating the massive debt that is being left for future generations of taxpayers to deal with.

The underfunding has been so bad that the city's actuary projects that by 2034, the Civilian System will be completely out of assets to pay retirement benefits—and that is assuming all of the actuarial assumptions, such as assumed rate of return, are correct.⁵

Hence, while the city claims that maintaining the status quo will lead to a fully funded Public Safety System, the

same status quo has the Civilian System *projected to go broke* in about 20 years.

3. Pension Debt Has Nearly Tripled Over the Last 10 Years

The difference between the current value of promised pension benefits and the current value of assets in a pension system is technically known as the unfunded liability, but can more commonly be thought of as pension *debt*. The unfunded liability is effectively the amount of retirement benefits that city officials have promised public sector workers, but for which they have not adequately saved to cover future costs.

With liabilities growing faster than assets, and Omaha city leaders failing to make the necessary annual savings payments—the recommended ARC—there has been a sharp increase in pension debt. According to the city's actuaries, from 2004 through 2013, the combined pension debt for all of Omaha's pension systems grew from \$320.2 million to \$827.8 million. Over the last decade, the Public Safety System's pension debt increased by \$387.8 million and the Civilian System's debt increased by \$119.7 million.

However, as bad as these numbers are, the reality is probably even worse. The estimates of unfunded liabilities by the city's actuaries are dependent on assumptions about

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the future that are not realistic.⁶ The Platte Institute has previously estimated that using less risky actuarial assumptions, Omaha's pension debt is likely closer to \$1.46 billion.⁷

Pension debt is a particularly problematic kind of debt for the city, because it is "off-balance sheet" debt. This means that while promising more pension benefits than the city actually saves to pay for *technically* means the city is incurring debt, *officially* the city doesn't count the pension debt on its books. This allows city officials to get around the legal restrictions designed to limit taxpayer debt in Omaha.

For example, Omaha has certain restrictions related to the kind of debt it can take on, such as a rule that at any given time the city cannot have outstanding general obligation bonds that are worth more than 3.5% of the value of taxable property.⁸ Currently this means that the maximum general debt the city can incur is \$977 million, and as of the most recent count the city has only \$498.1 million in outstanding general obligation bonds—leaving a debt buffer of \$478.8 million.⁹ However, if the city were required to count \$827.8 million in pension debt in the same category as borrowing to pay for other city services, then Omaha would presently be in violation of the city charter to the tune of \$349 million.¹⁰

Finally, as pension debt has grown, the debt payment part of the ARC has increased in comparison with the normal cost. Defined-benefit pension systems always have

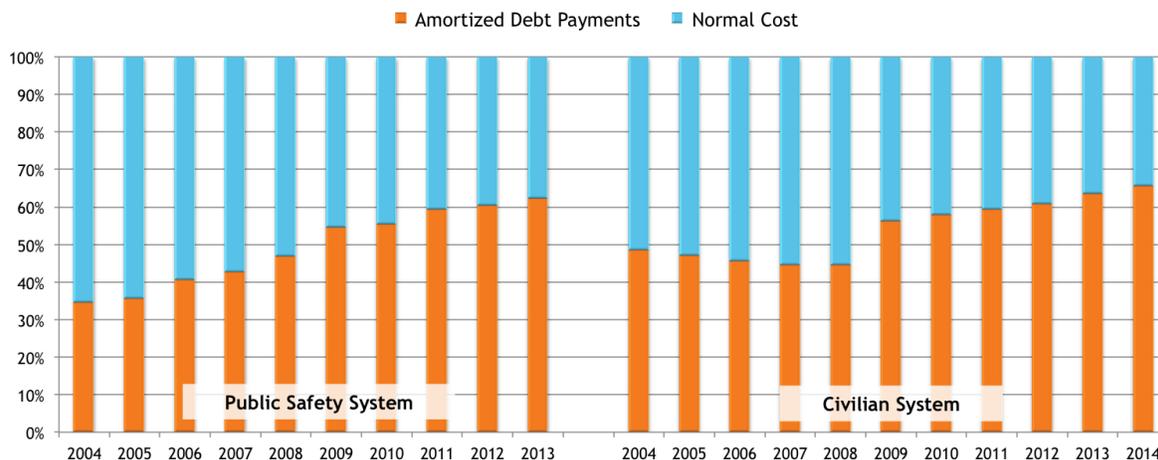
an annual normal cost because the city promises certain pension benefits every year. However, the only reason the annual required contribution includes a debt payment is that pensions have been underfunded in the past. Figure 3 shows that the debt payment has increased considerably as a percentage of the total costs of funding a pension each year. In addition, these debt payments are driving up the city's overall annual pension costs, as the next section shows.

4. Pension Costs are Consuming More and More Taxpayer Resources

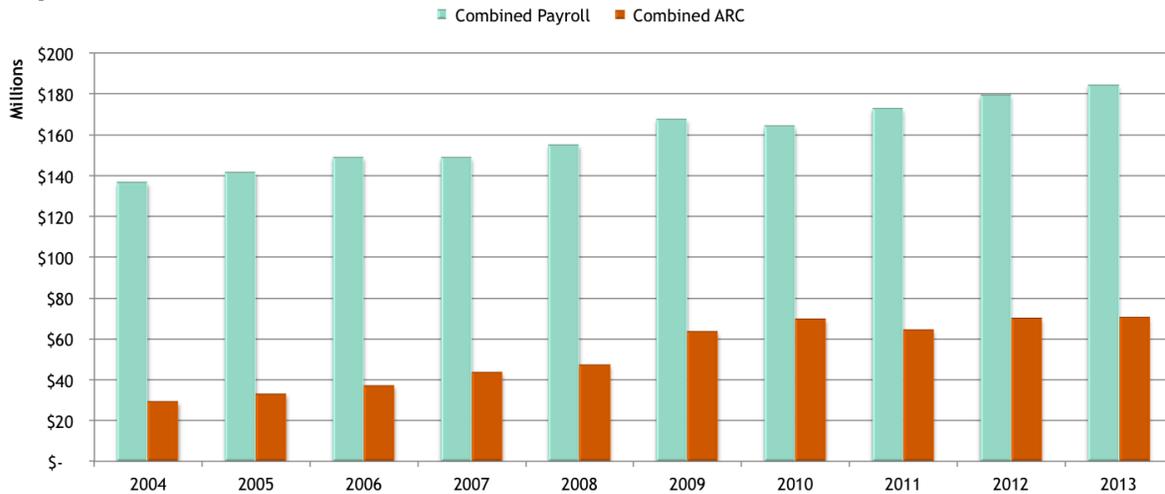
One important metric for determining the relative cost of a pension plan to taxpayers is the amount of annual required contribution relative to the total amount paid to employees each year. Ten years ago, the ratio between projected pension costs and the city's total payroll was about 1 to 5, but in fiscal year 2013 the ratio was about 1 to 2.5.¹¹ Figure 4 provides a visual representation of this, showing the combined payroll for the two systems (light green) and the combined actuarially recommended ARC (dark orange).

The total annual pension cost for the Public Safety System has grown from 26.5% of the payroll for police officers and firefighters in 2004, to 43.7% of the payroll in 2014. And pension costs for the Civilian System have grown from 13.2% of payroll to 27.5% of payroll over the last decade. Combined, the cost of funding pensions for

Figure 3. Growth in Debt Payments as a Percentage of Pension Costs



Source: Reason Foundation. Note: Authors' calculations based on data from PFRS and ERS valuations; figure uses normal cost rate and amortized debt payment rate as percentages of covered payroll.

Figure 4. The Recommended ARC for Omaha’s Pension Systems Rising Relative to City Payroll

Source: Reason Foundation. Note: Authors’ calculations based on data from PFRS and ERS valuations. Numbers reflect combined covered payroll and annual required contribution data. ARC as a % of covered payroll rises from 21.5% to 38.1% from FY2004 to FY2013.

employees in both systems has risen by more than 86% over the last 10 years.¹²

Because taxpayer dollars are a finite resource, every dollar that goes towards funding pensions means a dollar not spent elsewhere—on schools and parks, for example. There will always be some spending on pensions, but if Omaha had made the required pension payments in the past, then required debt payments today wouldn’t be as high and the ARC would be lower.

Effectively, the city’s underfunding in the past has created costs that are crowding out possible other spending in the present. If the city were to start paying 100% of the ARC, it would necessitate a serious change to the city’s budget. For example, last year Omaha skipped out on \$9.1 million in contributions to the Public Safety System and \$10.2 million in contributions to the Civilian System. If the city had paid this nearly \$20 million into the pension fund, it would have meant finding equal amounts to cut out of the budget, such as programs like street maintenance (\$25.4 million) or parks and recreation (\$25.9 million).

Another way to think about the growth of pension costs is that they are requiring the city to maintain certain taxes, such as the unpopular restaurant tax or property taxes, that might otherwise be cut.¹³ If the city had paid more into the pension system in the past, costs would otherwise

be lower today and might have enabled the city to reduce certain tax rates.

Root Causes of These Trends

These four interrelated trends have two primary causes. The first is related to economic events outside the control of the city, but the second is very much a direct cause of public policy decisions by previous leaders in Omaha.

1. Actuarial Assumptions About the Future Have Been Wrong

Pension systems can only work when the financial risk experts, i.e. actuaries, make accurate estimates about the future of investment returns, inflation, and health and mortality trends. But actuaries have missed the mark in two critical ways that have directly contributed to Omaha’s unfunded pension liabilities.

Investment Returns Have Not Met Expectations

To start with, city leaders and actuaries were incorrect in their estimates about the rate of return on investments for the Public Safety and Civilian Systems. For the last decade, Omaha has been assuming that it would earn 8% a year from investing pension fund assets.¹⁴ In some years,

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the city's investments did better than that, but in other years they did worse—particularly during the financial crisis. The result is that over the past decade the city has earned only an average of 6.56% a year for the Public Safety system, and 5.37% for the Civilian system.¹⁵

Figure 5 shows the annual rates of return over just the last decade for each of the two retirement systems, along with the difference between the assumed return and the actual return.

This collective information suggests the city's 8% assumed rate of return is overly optimistic. Using the last 30 years of data, it is possible to assume that the city could earn 8% to 9% on its investments over the next three decades. However, all savvy investors know, the past is not always the best predictor of the future. As such, pension funds should be cautious in projecting their future returns using data that is more than the last decade.

A lot has changed in 30 years and it may not be reasonable to assume that investment return patterns from the 1980s and 1990s should be included in projections about future returns—either for Omaha or anywhere else. In just the past decade and a half, financial markets have seen the dot-com bubble and bust, a surge of good years during the housing bubble, a stock market and real estate crash with the financial crisis, and the subsequent

reshaping of the American financial landscape with major regulatory overhauls and policy shifts by the Federal Reserve. Bond markets, equity markets, real estate prospects, and nearly every other asset class have been dramatically altered in perceptions about their fundamentals and how they operate.

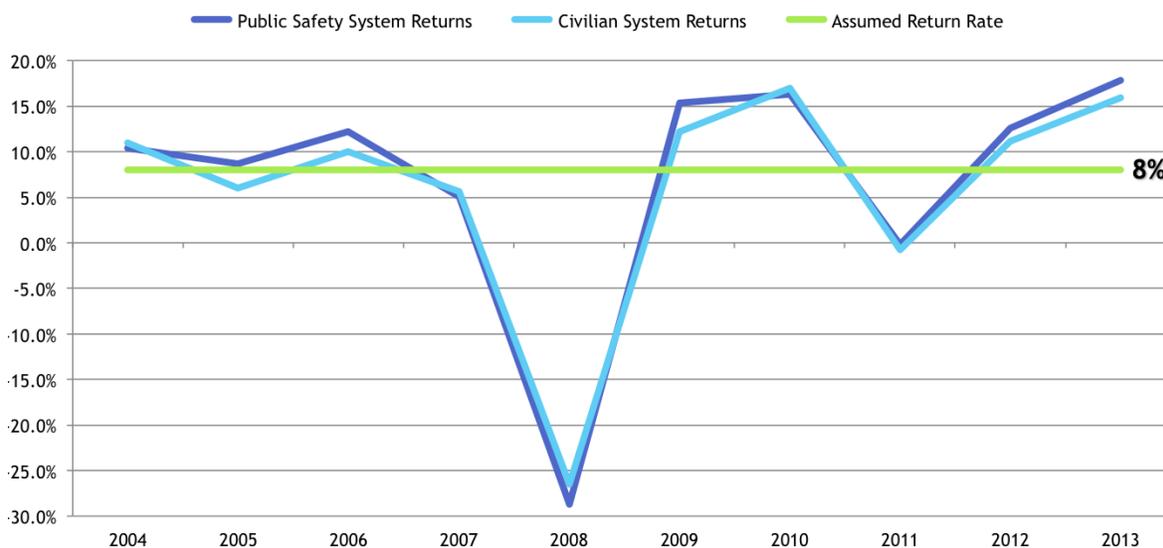
Appendix I offers a more detailed critique of Omaha's assumed rate of return, as well as a case for using a less risky discount rate than is currently adopted by Omaha's pension plans.

Life Expectancy Has Exceeded Expectations

Another area in which actuaries have been wrong in their assumptions is the life expectancy of retirees. When promising a guaranteed lifetime pension, it is important to have good estimates of how long people will live.

The way that actuaries measure life expectancy is actually through *death* rates. A lot of work goes into determining the odds that someone will survive given various conditions in society, and actuaries ultimately produce tables that show the probability of death or survival for certain ages and genders. Figure 6 shows mortality rates that actuaries used in 2004 and 2013. For example, in 2004, actuaries judged that there was just a 0.04% chance of a man dying at age 20, but that there was a 0.92% chance they would die at age 60.¹⁶ Notice the change in mortality

Figure 5. Actual Rates of Return Compared to Assumed Return
10-Year Averages: 6.6% (Public Safety) 5.4% (Civilian)



Source: Reason Foundation. Note: Data from PFRS and ERS valuations.

Figure 6. Mortality Rates Used for Omaha Pension Systems

Age	2004		2013		Reduction in Mortality Rates Between 2004-13	
	Males	Females	Males	Females	Males	Females
20	0.04%	0.02%	0.03%	0.02%	25%	0%
30	0.06%	0.03%	0.05%	0.03%	17%	0%
40	0.12%	0.07%	0.10%	0.07%	17%	0%
50	0.39%	0.16%	0.19%	0.15%	51%	6%
60	0.92%	0.42%	0.46%	0.41%	50%	2%

Note: Percentages are expected mortality rates, based on mortality tables listed in the PFRS valuation.

rates for 60-year old men between 2004 and 2013: they fell from 0.92% to 0.46%.

This is significant because reduced mortality rates mean larger liabilities. Mortality tables help pension systems estimate how much an individual on average will collect in pension payments. But if the life expectancy assumptions are wrong then the actuarially determined ARC won't be enough to save for future pension payments—even if the city did pay 100% of the annual required savings rate.

How This All Fits Together

As previously mentioned, actuaries annually calculate the total value of pension benefits that are being promised in a given year and try to determine how much should be saved in order to pay for those benefits. To calculate how much the city will ultimately have to pay out, the estimates about life expectancy have to be accurate. And because the amount being saved is going to be invested, the assumed rate of return on assets has to be precise.

Because investment returns have been lower than previously expected and contributions from the city lower than recommended, assets have grown slower than projected a decade ago. And because life expectancy has been better than anticipated, liabilities have grown faster than projected (Trend #1). With liabilities growing faster than assets, the pension system has added hundreds of millions in debt (Trend #3). And because annual pension costs include paying off debt, the cost of paying for pension expenses has nearly doubled over the past decade as a percentage of payroll (Trend #4).

2. Pension Managers Have Failed to Make Responsible Choices

While national investment trends and advances in life expectancy are outside the control of city officials, the prioritization and management of taxpayer funds and policies related to pension benefits are very much *within* their control. However, over the past decade city officials have failed to responsibly manage the costs of both the Public Safety and Civilian Systems.

Perpetual Underfunding

First, as previously mentioned, city officials have consistently failed to pay 100% of the annual pension bill for either pension system throughout the last decade (Trend #2), which has contributed to the slow growth in assets in the pension system (Trend #1).

It is true that beginning in 2010, the city started contributing more towards the Public Safety System. But as we showed in Figure 2, contributions still haven't reached 100% of the ARC, and the city has essentially done nothing to deal with the underfunding of the Civilian System.

Because the annual pension bill is based on how much should be saved this year so that the investment returns on that money can be used to help pay for future benefits, underfunding not only means failing to save but also undercutting possible investment returns. Future taxpayers then have to not only make up the difference on the amount not saved but also cover the never realized investment returns.

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Underfunding pension assets leads to growth in pension debt (Trend #3) and subsequently the growth in overall pension expenses every year (Trend #4).

No Limits Placed on Benefits

Second, these trends have been evident in annual valuation reports of the city's pension funds. City officials could have responded by temporarily or permanently changing the amount of pension benefits offered, increasing the age of retirement, slowing down or temporarily freezing the hiring of employees, or implementing a number of other policy changes designed to slow down the growth in pension liabilities so that pension assets could catch up.

It is true that the city has made a few small moves to curb the growth in liabilities. Starting in 2013, newly hired firefighters were no longer eligible to retire with full benefits at age 45 with 25 years of service, but instead have to reach age 55 with 10 years of service or age 50 with 20 years of service. And, since 2004, there has been a legal and political fight between city officials and the firefighter's union over staffing levels, albeit with little resolution.

However, if such steps have reduced liabilities, the results have been negligible. These limited changes do not represent the kind of robust attempts to curb the growth of pension liabilities that would have fundamentally improved the stability of Omaha's two pension systems.

Treating DROP As Pension Reform

Third, the city has decided to rely on the recently adopted Deferred Retirement Option Program (DROP) as a form of pension reform. The city's actuaries have projected that the program will generate some savings over the coming years, primarily through investing deferred retirement payments on behalf of the employee and taking at least 50% of the returns for paying down pension debt, and by requiring employees in the DROP to continue making contributions.¹⁷ However, the best-case scenario in their projection is that the savings will reduce the time that it will take for assets in the Public Safety System to catch up to liabilities by just two years—from 24 years down to 22 years.

Even if these projected savings were more significant, it would nevertheless not constitute genuine pension reform because it is dependent on the same failed actuarial analysis that contributed so much to the current trends in the

first place—both an unrealistic assumed rate of return and underestimated life expectancy rates.

Moody's Investors Service recently downgraded Omaha's bond rating from Aa1 to Aa2, in part citing the growing unfunded liability for the city's pension plans. However, an additional factor behind the rating is that Moody's uses a model to assess municipal pension systems that fundamentally rejects the notion of Omaha's DROP as substantive pension reform. Savings projections for the DROP are dependent on the city's 8% assumed rate of return and discount rate being correct. Moody's rejects the reliability of an 8% rate and currently uses a discount rate for municipal pension systems that is closer to 4.5%.¹⁸

While a discount rate built on Moody's assumptions may not be a politically feasible target, the variance between the proposed approach and the city's approach should serve as a warning that the current assumption is too high.

Appendix II offers a more detailed critique of the savings projections from the DROP.

While the three changes present in the DROP will likely have some marginal effects on the Public Safety and Civilian Systems, the simple reality is that at most these changes slow the advance of Omaha's pension problem—they do nothing to reverse its course.

Principles for Reversing These Trends

The city of Omaha could improve its fiscal position by starting to contribute at least 100% of the ARC and possibly even additional down payments on the pension debt. And it could more accurately recognize the scope of that pension debt by using a lower discount rate and assumed rate of return.

However, these changes would not eliminate the possibility that future city leaders could reverse the policies. Therefore, the city should look for ways it can truly reform the system for providing retirement benefits to public employees.

Fortunately for Omaha, the dismal fiscal state of its pension system is not a unique problem in the United States.

Many other municipalities have faced—and continue to face—the same kind of challenging trends outlined in this paper. There are several alternatives to defined-benefit pension systems that have been adopted by cities, counties, and states around the country, and which Omaha could embrace. Whatever the alternative, it should embody the following principles:

1. Pension plans should be affordable, sustainable and secure.

The current defined-benefit pension structure for both the Public Safety and Civilian Systems means that the costs of funding retirement benefits are dependent on events in the marketplace and changes in life expectancy—both of which are outside the control of Omaha. The future retirement benefit system should have affordable costs that are sustainable for taxpayers and secure enough to not be reliant on good fortune.

2. Reforms should reduce, and then eliminate unfunded liabilities.

Any pension reform that closes the current retirement systems to new members, and then put future hires into a more sustainable and secure system, would stop the growth of liabilities that are dependent on actuarial accuracy. Closing the systems to new members would mean no additional employees getting benefit promises that are going to be underfunded, adding to the rest of the city's current liabilities. Over time this will allow Omaha taxpayers to eliminate the city's pension debt.

3. The pension reform process should strive for simplicity, clarity and transparency.

The best alternatives to the status quo would involve a system that does not require actuaries to look into their crystal ball for forecasting returns. The simplest approach could be to put all new employees in a defined-contribution retirement plan, similar to a 401(k), in which the city would contribute a set percentage of an employee's pay into an individual account, within which the employee controls the mix of investments. By definition, since defined-contributions do not guarantee a specific rate of return, there can never be unfunded liabilities; the city

would make its regular contributions to the employee's retirement account with no further funding obligations beyond that.¹⁹

Another approach could be to develop a “hybrid” plan in which the city contributes to a small defined-benefit plan alongside a defined-contribution plan.²⁰ A well-designed hybrid can mitigate financial risks to taxpayers, though would not completely eliminate the possibility that trends outlined in this paper might return in the future.

Finally, the city could also consider creating a so-called “cash balance” retirement plan that relies on lower discount rates when creating individual accounts for future employees, though the accounts are invested together in a lump sum. A cash balance plan would not necessarily protect the city from financial risk, avoid unfunded liabilities, or guarantee adequate benefits for retirees. The cash balance plan design may offer the promise of being a compromise, “win-win” solution, but in reality, it is prone to facilitating the creation of a poorly designed retirement plan. While cash balance plans may reduce some of the risk for the plan sponsor while still providing employees with some guarantees, there may be better ways to get that guarantee.

In summary, when there is an opportunity to transition away from a traditional defined-benefit plan, policymakers should consider the following hierarchy: true defined-contribution plans as a first option, followed by a hybrid defined-benefit/defined-contribution plans as the second option, and carefully constructed cash balance plans as the third option. Whatever the reform, it should remove the temptation and the ability of future policymakers to reverse course midway through the reform process so that all participants involved can be confident in the future of retirement funding in Omaha.

Conclusion: Real Pension Reform Means Changing the Status Quo

The only way to eliminate the problematic trends outlined in this policy brief is to adopt wholesale changes that replace the current systems with alternatives that do not depend on the city's financial risk specialists being better in their forecasting than they have been in the past

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decade. Any changes to the current structure that leaves taxpayers exposed to the unpredictability of investment returns and medical technology should not be considered robust “pension reform.”

Appendix I: The Case Against the 8% Discount Rate

Defined-benefit pension plans like the Public Safety and Civilian System require actuaries to use two important measures: an “assumed rate of return” to project how investment returns will grow the assets in the pension fund; and a “discount rate” for determining net present value of pension liabilities.

The assumed rate of return and the discount rate are important for determining normal cost and the annual debt amortization payment.²¹ If the rate of return underestimates future returns, and the discount rate turns out to be lower than necessary, the result is a pension system that is well funded and where taxpayers have saved more than enough to pay off promised pension benefits. However, if the rate of return overestimates future investment growth, and the discount rate under projects the future value of liabilities, then the result is a pension system mired in debt and without the ability to pay retirees their promised benefits.

Currently, Omaha is using an 8% assumed rate of return and discount rate. Unfortunately, this has proved to be an overestimate of investment performance over the past decade, and for five important reasons, 8% is also is an unrealistic projection about the future.

1. If Omaha were regulated like a private sector company, they would have to use a discount rate closer to 6.1%.

First, private sector companies that have defined-benefit pension plans for their employees are regulated by a separate set of rules than government employer defined-benefit plans like Omaha.²² To start with, in the private sector the Financial Accounting Standards Board (FASB) does not allow companies to use their assumed rate of return as the discount rate. Pension systems can base their

assumed rate of return on the historical returns of their investment portfolio and the specific investment strategy they are taking with those assets, but the discount rate is determined separately.

Federal regulations dictate how the discount rate can be defined, with the Internal Revenue Service (IRS) providing detailed guidance. Private sector defined-benefit plans are required to use separate discount rates for the pension liabilities of employees who are within five years of retiring, are between five and 20 years of retiring, and are estimated to be 20 or more years away from retirement. The IRS releases regular tables with the rates that can be used for the liabilities that fall into these different segments.

The discount rates that federal regulations dictate are based on a high-quality corporate bond yield curve, meaning the discount rate for private sector defined-benefit plans is unrelated to the historic performance of any one specific retirement system.

If Omaha were a private sector company, regulations would dictate that the current discount rate for valuing pension liabilities would be just 6.1%—much lower than the current 8% discount rate being assumed by both the Public Safety and Civilian Systems.²³

2. Moody's Investors Service suggests a rate closer to 4.5%.

In 2012, Moody's Investors Service (MIS) released a new methodological approach for how it would value the liabilities and assets of municipal pension plans like Omaha's defined-benefit systems. The research service of the famed ratings firm argues that their approach improves the “transparency” of pension liabilities in their attempt to avoid a widespread problem of “understated” pension debt.²⁴

The MIS methodology uses a high-grade, long-term corporate bond index to discount the net present value of pension liabilities. While a number of quality indices exist, most long-term investment grade bond indices show yields of between 4% and 5% over the past two years. *For January 2014, the Moody's seasoned triple-A corporate bond yield was at 4.5%—again much lower than the current discount rate in Omaha.²⁵ And in January 2013, the same index was at 3.8%.*

3. Academic research suggests a rate between 4.2% and 2.3%.

There is a large body of academic literature in financial economics that also argues it is a mistake to use the assumed rate of return to as a means of valuing pension liabilities—i.e. to use the rate of return as the discount rate.²⁶ The most recent academic research has suggested cities like Omaha might best protect taxpayers by using a discount rate based on either a municipal bond index, or the Treasury yield curve.²⁷

Figure 7 shows the yields on a high-grade, 20-year municipal bond index, alongside 10-year and 30-year Treasury bonds.²⁸ Over the past three years, the municipal bond index has averaged 4.2%, while the 10-year Treasury bond and 30-year Treasury bond have averaged 2.3% and 3.3% respectively. Collectively, this suggests a discount rate for Omaha somewhere between 4.2% and 2.3%.

4. Omaha’s historic investment performance suggests there is only a 15% chance of earning an 8% rate of return.

Fourth, while the private sector and academics are opposed to using the assumed rate of return as a means of determining the discount rate for valuing liabilities, there are no federal laws restricting state and local pension

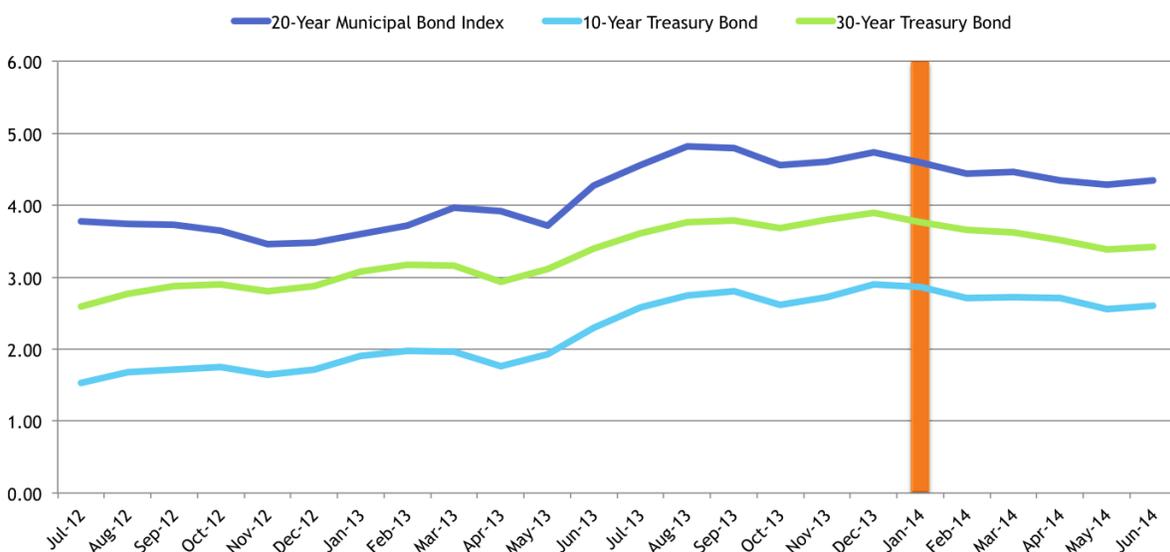
funds from following that practice. GASB has recently changed its reporting requirements to be more in line with the national standards, and pension liabilities that are underfunded will be required to use a discount rate related to high-grade municipal bond yields. However this requirement only applies to *reporting*, not to funding practices.

Technically, Omaha will be able to report its liabilities using the GASB determined discount rate, but for the purposes of determining its actual contributions, the city can still use 8%.

However, even assuming that Omaha continues to use its historic investment performance in order to project an assumed rate of return, and then also use that figure as the discount rate, there remains a question as to what time frame should be used when assessing historical investment returns.

The current 8% assumed rate of return might be a reasonable expectation based on the last three decades of investment return data. But a lot has changed in 30 years. In just the past decade and a half, financial markets have seen the dot-com bubble and bust, a surge of good years during the housing bubble, a stock market and real estate crash with the financial crisis, and the subsequent reshaping of the American financial landscape with major regulatory overhauls and policy shifts by the Federal Reserve.

Figure 7. Municipal Bond and Treasury Bond Yields, 2012–2014



Source: Reason Foundation, Federal Reserve Bank of St. Louis

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Bond markets, equity markets, real estate prospects, and nearly every other asset class have been subject to dramatically altered perceptions about their fundamentals and how they operate.

Given these changes, it is no longer reasonable to include investment return patterns from the 1980s and 1990s in projections about future returns—either for Omaha or anywhere else. One lesson of the financial crisis was that serious, unforeseen events in the marketplace are a reality that modern finance hasn't magically defeated through the power of risk analytics. A second lesson is that age-old wisdom—like housing prices never going down—should be taken with a grain of salt.

This analysis suggests that if past investment data is to be used for projecting future returns, at most we should use 10 years of data (and even then, the resulting projection should be assumed to be optimistic). Between fiscal years 2004 and 2013, the Public Safety System averaged a 6.56% annual rate of return on its investments, while the Civilian System averaged 5.37%.²⁹

Based on the last 10 years of investment return data for (separately) the Public Safety and Civilian Systems, the probability of an 8% rate of return over 30 years is less than 15% for either system.³⁰

There is a 5% to 10% chance that the Civilian System will achieve its 8% target rate of return.³¹ The Public Safety System has had stronger investment returns, but even so there is only a 10% to 15% chance that this system gets an 8% return.³²

While it remains inappropriate to use rates of return to determine a discount rate, it may be that the city will not want to abandon this approach, not least because it is still technically permissible practice under GASB rules. Examining projections for the two systems to see where lower expected returns might fall, there is a 25% to 40% probability of achieving the 6.1% rate of return that private sector guidelines would suggest.³³ And there is a 50% to 60% chance that the high-yield corporate bond index rate of 4.5% could be achieved.³⁴

Collectively this suggests that Omaha has a very low probability of meeting its assumed rate of return in the coming years, thus making the discount rate also unrealistic.

5. The national trend is towards lowering assumed rates of return.

Finally, it should be clear that much of the debate over how to set an assumed rate of return comes down to how best to think about the future. The academic literature argues that pension plans should *never* use their own historic investment performance to determine a discount rate. Both the Moody's Investors Service guidance for municipalities and federal regulations for private sector defined-benefit plans use corporate bond yields to guide expectations about the future. The question is whether state and municipal governments will adopt the private sector standards or continue to use past investment returns as an indication of future performance.

The recent change in GASB standards for reporting pension finances is a push in the direction of private sector standards for public sector pension funds. Already, there has been a slow trend amongst states, cities, and counties away from using higher discount rates. Over the past decade of the top 110 state level pension plans, 45 have lower their discount rates from 8% or higher in 2004 to less than 8% by 2013.³⁵ And only 12 states now use a discount rate of 8% or higher for all of their state level employees.

This trend towards lower discount rates is still rooted in the idea that the assumed rate of return on assets can responsibly be used to discount the value of pension liabilities. However, because it is moving towards the discount rates used in the private sector, the net result is, nevertheless, more responsible pension system management overall.

Appendix II: The DROP is Not Pension Reform

Omaha recently adopted a "Deferred Retirement Option Program" for both the Public Safety and Civilian Systems. This program gives employees the option to retire, then be immediately rehired, and have their monthly pension benefits paid into an account managed by the city for three to five years.

While the DROP could generate some savings for the two pension systems in theory, such savings have been and will

be small relative to the size of the pension debt Omaha has accrued. Moreover, because the DROP relies on the same set of problematic actuarial assumptions as the rest of the defined-benefit system, such a program cannot be considered the kind of substantive reform to the status quo that Omaha needs.

Under the system, the employee continues to be paid a salary for their current role while at the same time starting to collect theoretical pension benefit checks. The pension checks are not actually distributed to the employee, but are notionally earmarked for the employee within the asset pool of the larger pension system.

The employee continues to make contributions into the pension fund, but they do not accrue any additional years of service. Once the three to five year DROP period is over, the monthly pension benefits continue at the same rate they were at during the DROP period, and the employee gets a lump-sum payment of all monthly pension benefits that had been set aside during the DROP period.³⁶

How Does the DROP Benefit Employees?

The benefits to the employee are that they effectively continue to earn a salary while also getting paid monthly pension benefits. The employee's salary is effectively reduced by whatever the employee contribution rate to the pension fund is, because that money does not go towards their benefits—which were calculated and fixed at the time the DROP period started. However, the employee does get paid interest on the pension benefits being set aside for them during the DROP period.

How Does the DROP Benefit the Omaha Pension Systems?

The pension systems benefit because they can encourage earlier retirement, and reduce liabilities slightly by fixing pension benefits at a rate with three to five fewer years of service in the benefit calculation. The pension systems also do not bear the costs of continuing to pay the employee a salary during the DROP period. Of course, those costs are borne by the city, so from the perspective of taxpayers this distinction is not as important as the net cost of the program to the city budget.

The pension systems also benefit because instead of actually paying out retirement checks each month, it gets to keep the funds (theoretically being deposited into an individual account) that otherwise would be outlays and invest that money during the three to five year period. Omaha's DROP allows for the interest rate paid to employees on the deferred pension benefits to be between 0% and 7%, but the total rate is not to exceed 50% of the actual rate of return on assets each year. This means that the pension systems will either collect a windfall from investing the deferred retirement benefits—which when added to the assets of the pension system reduces pension debt—or at least won't have to pay out any interest (if investment returns on the years are not positive).

Will the DROP Save Taxpayers Money?

There are a few factors that will determine whether the DROP saves Omaha's taxpayers money. One factor is whether any savings credited to the pension systems from the DROP reduce the unfunded liability by a greater amount than the city pays out in salaries for employees during the three to five year DROP period. The DROP is designed with the explicit mandate that it be "at least cost neutral to the pension system." However, in years where the DROP is cost neutral to either the Public Safety or Civilian Systems, *the net affect will be taxpayers losing money* as there is still the cost of the salaries being paid to workers during the DROP period.

(Even if the employees who retired were replaced—a somewhat contentious issue in Omaha—veteran employees usually make substantially more than the entry level employees that would replace them, meaning there still is some salary cost for paying employees during a deferred pension period.)

Another factor is how much the city actually earns on its investments. In years where investment returns are greater than 14%, the city will not only reap a 50% windfall on the invested deferred benefits, but will also get every investment return dollar above the 14% line as well. In years where the city earns little to no return, however, there could be no windfall to help pay down the pension debt and improve the funding ratio.

Is the DROP Enough to Reverse the Negative Trends? No.

A report from the city's actuaries found that adopting an "at least cost neutral" DROP would save the Public Safety System enough money that assets would catch up with liabilities by 2036, instead of 2038 as is currently projected.³⁷ This best-case scenario, in which the system is fully funded (i.e. has no more pension debt), assumes that the city earns 8% a year for the next 24 years *and* that life expectancy rates remain the same for the next 24 years.³⁸

For reasons detailed earlier in this paper, these are foolish and ultimately irresponsible assumptions.

As pointed out above, the probability of realizing an 8% rate of return on investment is very low (see Appendix I). Furthermore, in just the past decade there have been remarkable advances in life expectancy rates—and the pace of innovation in medical technology is only getting faster.

The Deferred Retirement Option Program does create the possibility of savings within the pension system. But the projected savings are quite small and even those savings are based on precisely the unrealistic assumptions that have contributed to the problematic trends facing Omaha today. In short, DROP will not be enough to eliminate Omaha's pension debt or to substantially reduce the net cost to taxpayers of providing a defined-benefit retirement plan to the city's public sector employees.

Related Material from Reason Foundation and Platte Institute

- "The "Transition Costs" Myth: Why Defined-Benefit to Defined-Contribution Pension Reform Is Commonly Misunderstood," by Anthony Randazzo, Reason Foundation, October 28, 2014, <http://reason.org/news/show/the-transition-costs-myth>
- "Best Practices in Pension Reform: Lessons Learned from Successful Reformers," by Lance Christensen and Adrian Moore, Reason Foundation, September 29, 2014, <http://reason.org/news/show/best-practices-in-pension-reform>
- "Pension Reform Case Study: Michigan," by Anthony Randazzo, Reason Foundation, March 17, 2014,

<http://reason.org/news/show/pension-reform-case-study-michigan>

- "Pension Reform Case Study: San Jose," Adam Summers, Reason Foundation, February 18, 2014, <http://reason.org/news/show/pension-reform-san-jose>

Endnotes

1. Andrew G. Biggs, "Honest Accounting and Public Employee Pensions in Nebraska," Platte Institute, May 2013 <http://bit.ly/11fktFF>; David J. Kramer, "Nebraska's Public Pension System: Repeating Our Successes Will Lead Us to Solvency," Platte Institute, June 2013, <http://bit.ly/1BJH1iA>; Andrew G. Biggs, "Protecting Omaha's Future: Confronting the Challenge of Public Pension Reform," Platte Institute, June 2014, <http://bit.ly/1k433Po>.
2. More technically, actuaries for the city determine the net present value of pension liabilities—discounting at a rate similar to the expected return on investments. Then they use that measure of liabilities to compare with the total value of assets in the pension fund.
3. Actuaries determine normal cost in part using assumptions that are determined by pension boards, such as the discount rate. As such, the accuracy of actuarial estimates is somewhat dependent on factors outside their control. However, actuaries usually are providing guidance to the pension boards they work for as to what the best practices are for deciding actuarial assumptions, so their control over the estimates they ultimately produce is substantial.
4. Part of the reason for the increase in contributions to the Public Safety System is that the 2010 collective bargaining agreement between the city and police and fire unions required the city to do so. See http://www.platteinstitute.org/Library/docLib/20130621_Kramer_Pension_Paper.pdf (p.6)
5. See the Employees' Retirement System 2014 valuation, page 6: "Given the current scheduled contribution rates, the contribution shortfall is expected to increase, the funded status is expected to decline and the System assets are expected to be exhausted in

about 20 years even if all actuarial assumptions are met (including an 8% return on plan assets).”

sector companies—both of which suggest using bond indices to discount liabilities.

6. Specifically, there is less than a 15% chance that the city will achieve its assumed rate of return of 8%, as we outline in Appendix I. And the city uses its assumed rate of return to discount the value of its pension liabilities. Therefore, the value of pension liabilities is most likely significantly underestimated based on the current city actuarial assumptions.
7. Platte Institute used a 4% discount rate to estimate the value of Omaha’s pension debt, a defense of which can be found in Andrew G. Biggs, “Protecting Omaha’s Future: Confronting the Challenge of Public Pension Reform,” Platte Institute, June 2014, <http://bit.ly/1k433Po>.
8. See Article V, Section 5.27, of the City Charter of Omaha.
9. See page 18 of the 2014 Omaha budget proposal summary, <http://bit.ly/1u4rIHd>.
10. If the pension debt were even higher, based on using a more realistic discount rate, then the city could be even more substantially in violation of the city charter.
11. We measured the actuarially determined annual required contribution (ARC) as a percentage of covered payroll. In FY2004, the combined ARC for the Civilian and Public Safety Systems as a percent of covered payroll was 21%, but in FY2013 it was 38%.
12. The combined ARC and covered payroll data show an 86.3% growth in ARC as a percent of covered payroll.
13. KETV.com, “Restaurant tax named third-largest revenue generator,” <http://bit.ly/1ygFWJa>
14. This is significant in part because defined-benefit pension systems (like the Public Safety and Civilian Systems) use a “discount rate” in order to determine the net present value of promised pension liabilities and Omaha uses their assumed rate of return as a means of deciding their discount rate. This is out of step with the national standards as proposed by Moody’s Investment Service and federal regulations for private sector companies—both of which suggest using bond indices to discount liabilities.
15. It is worth noting that when measuring the average return on investments, actuaries use geometric means to calculate average returns (as opposed to arithmetic means). This is because investment returns are not independent events. If the fund earns below the 8% goal in one year, it will have less in capital than anticipated to invest for the following year. This means in the years following particularly bad years investment funds have to do particularly well to make up the difference. For example, in 2011 the Civilian System had a return of about -1% on its investments. It would have needed to earn around 18% in the following year—not 17%—in order to make up the difference and achieve an 8% average.
16. These figures are drawn from the mortality tables provided in the FY2004 and FY2013 valuations for both the Public Safety and Civilian retirement systems.
17. When employees elect to join the DROP their pension benefit is fixed based on the current final average salary and years of service, but they will continue to make contributions to the pension system during the years of their deferred retirement.
18. As we discuss in Appendix I, Moody’s Investors Service does not use rates of return to define discount rates, but instead uses a high-grade, long-term corporate bond index to discount the net present value of pension liabilities. While a number of quality indices exist, most long-term investment grade bond indices show yields of between 4% and 5% over the past two years. For January 2014, the Moody’s seasoned triple-A corporate bond yield was at 4.5%.
19. It is very important to note that defined-contribution plans can be designed to include some defined-benefit characteristics, even while eliminating the potential for unfunded liabilities and financial risks to the sponsor. For example, defined-contribution plans can be designed to require that a portion of the contributions be dedicated to a guaranteed annuity product in order to provide the beneficiaries with some level of guaranteed income in addition to the remaining defined-contribution plan balance. This offers a higher likeli-

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hood of benefit adequacy for retirees while shifting the risk of the annuity component to the insurance company provider or other annuity plan provider (as opposed to government bearing the risk if a defined-benefit plan misses its rate of return target). Even if the defined-contribution plan sponsor does not want to mandate that some portion of an individual's investment be dedicated to an annuity product, the plan can still be designed to require that some portion of an individual's accumulated assets be received as a guaranteed lifetime income product upon retirement.

20. Utah's 2011 pension reforms offer a good illustration of a hybrid approach. The state closed its defined-benefit pension system to new employees and created a new two-tier retirement system to replace it. New employees now have the option of participating either in a full defined-contribution plan or in a stacked hybrid defined-benefit/defined-contribution plan. The state set in statute that it was going to pay 10% of an individual's salary toward the retirement plan of their choice (12% for public safety workers). Employees can choose to put that 10% of their salary in a 401(k) plan professionally managed by Utah's state retirement system, or they can choose to place their 10% into a defined-benefit pool via the hybrid plan. However, if the worker chooses the hybrid plan option, then they are required to make the full actuarially required contribution each year. If the markets perform well in a given year—and the contribution rates towards that new hybrid plan go down—then the additional funds are placed into a 401(k) plan. But if the markets do poorly and contribution rates are required to increase, then any contributions required over the 10% level would be automatically deducted out of that employee's paycheck to maintain actuarial funding; the state would not bear this risk.
21. Actuaries determine annually how much will be needed in the future to provide the benefits promised to existing workers, then they work backwards from there using assumptions about how much the pension fund will earn investing each year's payments, how long retirees will live, etc. to figure out how much has to be paid in that year to fund the system. That amount is the "normal cost" needed today to grow over time and pay out benefits in the future.
22. Regulations governing public sector pensions today are mandated by: Pension Protection Act of 2006, Moving Ahead for Progress in the 21st Century Act (2012), and Highway and Transportation Funding Act of 2014.
23. Methodology: IRS Adjusted 24-Month Average Segment Rates for plan years beginning in 2014 are 4.99% (First Segment, for employees anticipated to retire in five years or less), 6.32% (Second Segment, for employees anticipated to retire in between five and 20 years), and 6.99% (Third Segment, for employees anticipated to retire in more than 20 years). We used the assumption that vested employees in either of the two Omaha pension systems are anticipated to retire in 20 years or less. This assumption is based on vesting periods of five years to 10 years (for most employees across both systems), as well as the average age of vested employees, 48.5 years old in the Public Safety System and 49 years old in the Civilian System. Based on this we could apply an average discount rate of 5.66% for vested employees and 6.99% for non-vested employees. We measured the percentage of employees in the two pension systems that are vested, and used these to weight the application of the particular discount rates to the whole of the two pension systems. The result was an average discount rate of 6.19% for the Public Safety System, and average discount rate of 6.07% for the Civilian System. The combined average discount rate of 6.13% (rounded) is what we have reported in this policy brief. Sources include the 2014 valuation for the Police & Fire Retirement System (pg. 33), the Employees' Retirement System (pg. 30), and the *Internal Revenue System's* "Funding Yield Curve Segment Rates" Funding Table 3.
24. Source: *Moody's Investors Service*, "Moody's proposes adjustments to US public sector pension data," July 2, 2012, <http://bit.ly/1qghRRA>.
25. Source: *Federal Reserve Bank of St. Louis Economic Research Database*, "Moody's Seasoned Aaa Corporate Bond Yield," <http://research.stlouisfed.org/fred2/series/AAA>.
26. Lintner, L. (1965), "The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios

- and Capital Budgets,” *Review of Economic Statistics* Vol. 47, 13-37; Modigliani, Franco and Merton H. Miller (1958), “The Cost of Capital, Corporation Finance, and the Theory of Investment,” *American Economic Review* Vol. 48: 261-297; Novy-Marx, Robert and Joshua Rauh (2011), “Public Pension Promises: How Big Are They and What Are They Worth?,” *Journal of Finance*, Vol. 66, No. 4: 1211-1249; Sharpe, W.F. (1964), “Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk,” *Journal of Finance* 19, 425-442; Treynor, Jack L. (1961), “Toward a Theory of the Market Value of Risky Assets,” Unpublished Manuscript.
27. See Novy-Marx, Robert and Joshua Rauh (2009), “The Liabilities and Risks of State-Sponsored Pension Plans,” *Journal of Economic Perspectives*, Vol. 23, No. 4: 191-210; Novy-Marx, Robert and Joshua Rauh (2011), “Public Pension Promises: How Big Are They and What Are They Worth?,” *Journal of Finance*, Vol. 66, No. 4: 1211-1249; Novy-Marx, Robert and Joshua Rauh (2011), “Policy options for state pension systems and their impact on plan liabilities,” *Journal of Pension Economics and Finance*, 10, pp 173-194.
 28. Source: *Federal Reserve Bank of St. Louis Economic Research Database*, “Bond Buyer Go 20-Bond,” “10-Year Treasury,” “30-Year Treasury,” <http://bit.ly/11neTAV>.
 29. These figures represent the geometric means for FY2004 to FY2013 investment returns. Note: If we expanded out the range to include the years right after the dot-com bubble burst, we actually find lower average return rates. Therefore, we find the 10-year historical data provides a more conservative estimate than expanding out a few more years.
 30. Methodology: This projection is only an approximation, limited by publicly available data. We used the annual investment returns from FY2004 to FY2013, as reported in the actuarial valuation reports to get the mean annual return and its volatility measured by the standard deviation. These were then used in a standard Monte Carlo simulation (10,000 iterations) for projecting the odds for different rates of return. Using historic results over a long-term would change the analysis. Using the investment returns for each asset class independently to project the odds of future rates of return would also change the analysis, and create a more accurate picture. Without that publicly available data we were not able to refine our model, and as such it presents simply an approximation for the odds of Omaha’s achieving an 8% rate of return over 30 years. However, given that a discount rate for a high-yield corporate bond index consistently falls at the 50th percentile or better in our model, we stand by the results as providing a useful approximation of the odds of Omaha achieving an 8% rate of return.
 31. Our projections show the probability of an 8% return usually fell at the 92nd percentile.
 32. Our projections show the probability of an 8% return usually fell at the 87th percentile.
 33. Our projections show the probability of a 6.1% return fell between 60th and 75th percentile.
 34. Our projections show the probability of a 4.5% return fell between 40th and 50th percentile.
 35. This calculation is based on our own review of all 50 state pension systems and their largest plans.
 36. This lump sum can also be put into an annuity for an annualized payout.
 37. October 14, 2014 letter from Cavanaugh Macdonald Consulting, LLC to the Board of Trustees for the City of Omaha Police and Fire Retirement System, subject Projections of Long Term Funding.
 38. It also assumes that 70% of Public Safety employees elect a five-year DROP for the next 24 years.

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