WebMemo

Published by The Heritage Foundation

No. 3462
January 18, 2012

States Created Their Public Pension Problems, and States Should Solve Them

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Although underfunded state and local government public pension plans pose a very real threat to our national economy, "a federal bailout of the states should be avoided at all costs," says a new report by the Senate Finance Committee Republican staff.[1] This is an appropriate policy response. The citizens of states that have handled their public pension plans responsibly or made the appropriate changes to reform them should not be asked to bail out states that have acted irresponsibly.

The report reminds policymakers that "unfunded pension liabilities of state and local governments also affect the Federal government's credit rating" and warns that a significant state or local insolvency could place additional burdens on the federal government. What is worrying is that the report appears to make a case for some form of federal intervention rather than leaving the problem for the states to solve. The report notes that "a new design for public plans is needed" and ends by saying that a "legislative solution for consideration by Congress will be introduced in the Senate in the near future."

Public Pension Plans Face Trillions of Dollars in Underfunding. Today, 31 states are sponsoring public pension plans with funding ratios that are under 80 percent of what is needed to pay full benefits. Funding ratios measure a pension plan's current assets, projected contributions, and investment earnings in relation to its predicted benefit obligations. A ratio that is under 80 percent indicates that the plan is in severe trouble and will have great difficulty meeting its obligations. This is not a small problem. A significant 2010 academic study[2] estimates that 116 major state-sponsored pension plans have assets of about $1.8 trillion—to pay pension promises of between $3.6 trillion and $5.2 trillion. This leaves a gap of between $1.8 trillion and $3.4 trillion. A follow-up study[3] found that major pension plans for municipal workers in 50 major cities add an estimated $574 billion to the problem.

Fixing the problem will not be easy. Over the past two years, 41 states made changes to one or more of their state employees' pension plans,[4] with some of them visiting the issue more than once.

The most obvious options are increasing government and/or employee contributions or restructuring the pension plan by changing benefit formulas, retirement ages, or inflation indexing.

However, even seemingly dramatic changes leave high levels of underfunding. For instance, Rhode Island cut its underfunding by $3 billion after increasing the retirement age to 67, suspend-

This paper, in its entirety, can be found at:
http://report.heritage.org/wm3462

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
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Washington, DC 20002–4999
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ing cost-of-living allowances (COLAs), and moving state employees to a hybrid form of pension plan.[5] However, even these radical changes still left the state with a $4 billion shortfall that it will have to resolve through other means.

Defined-benefit Pensions Are Opaque. Most state and local governments have established traditional "defined-benefit" pension plans for their workers. These plans offer a guaranteed benefit that is usually based on a percentage of some measure of the employee's income times the number of years that he or she is employed by that government. For example, a plan might pay a monthly benefit equal to 2 percent of the average of the employee's last three years' wages for each year of tenure. In the case of an employee whose average last three years' income equals $60,000 and who worked for the government entity for 20 years, that formula would equal an annual pension of $24,000 plus any cost-of-living changes.

There is nothing inherently wrong with a defined-benefit plan if it is responsibly structured and administered. Unfortunately, these plans are complex, and it is very difficult for employees, legislators, or taxpayers to determine if they are fully funded and well managed. Features such as offering benefits at an early age or generous benefit formulas can add to the ultimate cost.

Even if a defined-benefit pension plan's funding ratio is available for review, its calculation depends on accurate predictions of what investments will earn in the future, regular and adequate contributions from the employer and/or the employee, and how long current and future retirees will live and collect benefits. An inaccurate projection for any one of these elements can make the funding ratio meaningless, and unfortunately, it usually takes an impartial expert to detect a problem. Thus, a pension plan could look well funded but in reality face severe financial problems. For example, if a funding ratio is based on projections that the plan will earn 8 percent on its investments, but it is actually likely to earn 6 percent, the plan will end up being underfunded regardless of its ratio.

Who Bears the Risk if a Defined-benefit Pension Plan Runs into Problems? All pension and retirement savings plans are risky; the only question is who bears the risk. In a retirement savings plan, the individual bears all risk, while in a private-sector defined-benefit pension, most of the risk goes to the employer. If the employer fails, leaving an underfunded pension plan, the risk is divided between the federal Pension Benefit Guaranty Corporation (PBGC), which insures pension benefits up to a set dollar amount, and the employee for any pension payments above those paid by PBGC.

A state or local government pension plan is different, because the ultimate risk is borne by the taxpayer. The PBGC does not insure state and local government employees' pension plans, so if one of these is poorly managed or the legislature fails to make timely and adequate contributions, that jurisdiction's taxpayers will be expected to pay higher taxes or face reduced services to make up the difference. This is a good reason for taxpayers to be very wary if their state or local government offers

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1. Press release, "Hatch Releases Report Detailing Threat of $4.4 Trillion Public Pension Debt," Committee on Finance, U.S. Senate, January 10, 2012, at *http://finance.senate.gov/newsroom/ranking/release/?id=f9a92142-d190-4bca-a310-b43cb462eb45* (January 17, 2012).
2. Robert Novy Marx and Joshua D. Rauh, "Policy Options for State Pensions Systems and Their Impact on Plan Liabilities," prepared for the NBER State and Local Pensions Conference in Jackson Hole, Wyoming, August 2010, at *http://kelloggfinance.files.wordpress.com/2010/07/nmr_posps_20100718.pdf* (January 17, 2012).
3. Robert Novy Marx and Joshua D. Rauh, "The Crisis in Local Government Pensions in the United States," National Bureau of Economic Research, October 2010, at *http://www.kellogg.northwestern.edu/faculty/rauh/research/NMRLocal20101011.pdf* (January 17, 2012).
4. Ronald K. Snell, "Pensions and Retirement Plan Enactments in 2011 State Legislatures," National Conference of State Legislatures, December 31, 2011, at *http://www.ncsl.org/?tabid=22763* (January 17, 2012).
5. Executive Summary, "Rhode Island Retirement Security Act of 2011," Rhode Island General Assembly, November 17, 2011, at *http://www.pensionreformri.com/resources/ReportwithGRSAppendix.pdf* (January 17, 2012).

its workers a defined-benefit pension plan. At the very least, they should insist on accurate information that reflects the real risks that such a plan faces.

What Role Should Congress Take? Congress should have little or no role in state and local government employee pension plans. It should not step in and attempt to impose a solution, a model for reform, or a bailout of severely troubled states. Just as states and local governments created the public pension problems they now face, it should also be their responsibility to deal with these situations. Even with the best intentions, it would be fairly easy for a reform plan to end up including a full or partial bailout as an incentive for states to act.

Besides, data from the National Conference of State Legislatures (NCSL) show that federal action does not appear to be necessary. While the Senate Finance Committee Minority's report points out that a default or insolvency by a major state would have a negative effect on the national economy, NCSL data show that more and more states are taking actions that will reduce their underfunding. The states should be left to continue their efforts, prompted by pressure from taxpayers and the bond markets.

Congress should ensure that state and local government bond issues sold in national markets include a full and accurate disclosure of the risks, especially if any underfunded public pension programs might damage the issuing jurisdiction's ability to repay its debts as scheduled. Otherwise, Congress should remain watchful but refrain from action.

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