MERCATUS CENTER
George Mason University
Bridging the gap between academic ideas and real-world problems

ECONOMIC PERSPECTIVES

THE CRISIS IN STATE AND LOCAL PENSIONS

EILEEN NORCROSS AND EMILY WASHINGTON

Guaranteed pension benefits are a key feature of government employment for many state and local workers. However, flawed accounting methods have resulted in persistent underfunding of these promised benefits. In addition, because pensions are long-term liabilities, policymakers often choose to prioritize projects that voters will enjoy in the present rather than adequately funding these promised benefits. Correctly calculating pension obligations is the first step to implementing reforms that will protect both public-sector employees and taxpayers from accounting gimmicks that threaten pension fund solvency.

THE IMPLICATIONS OF GUARANTEED PENSION OBLIGATIONS

- *Budgetary implications*. Public employee pensions are guaranteed obligations of the state or local government and enjoy constitutional or statutory protection. This means that these benefits take priority over other areas of state and local funding like education, transportation, and human services.
- *Accounting implications*. Public employees' pensions are **guaranteed benefits**. **Pension funds' obligations will not decrease in response to poor market performance.** This means that pension fund liabilities need to be valued at the **risk-free** discount rate, or the rate of interest that the federal government pays on 15-year Treasury bonds. As of January 2015, that rate is about 2.11 percent.

THE DISCOUNT RATE AND THE EXTENT OF UNDERFUNDING

- Instead of using the risk-free rate, however, state and local policymakers often use expected stock market rates of return, which assume assets will have an annual return of 8 percent, to value pension liabilities. This represents a disconnect between pension benefits, which are guaranteed, and pension return assumptions, which depend on a risk premium.
- Using the expected stock market rate of return on assets to value pension fund liabilities makes public pensions appear much better funded than they really are. For example, Pennsylvania uses an expected rate of return of 7.5 percent to value its pension liabilities. Using the risk-free rate, its liabilities are 82 percent larger than they appear to be using the expected stock market rate of return. The first step in addressing the pension underfunding problem is for policymakers to accurately value pension liabilities by calculating their obligations under the risk-free discount rate.

STATE AND LOCAL POLICYMAKERS UNDERFUND GUARANTEED BENEFITS

In addition to underestimating liabilities and the annual required contribution (ARC)—the amount needed to fully fund promised benefits for decades—state and local policymakers in some cases have failed to contribute consistently to public employee pension funds. They face powerful incentives to skip or reduce the ARC, underfunding pensions.

The ideas presented in this document do not represent official positions of the Mercatus Center or George Mason University.

- Policymakers prefer to cater to current voters by spending on projects with immediate benefits and visibility, while pension funds are for retiree benefits decades in the future. By underfunding pensions, policymakers create the appearance of providing voters with benefits in excess of the value of current tax revenues.
- Promising higher pension benefits also disguises the full cost of public-sector employees by pushing costs into the future, freeing up current tax dollars for other uses.
- Using a high discount rate lowers the ARC to pension funds. However, this artificially low contribution makes it appear as if additional public employees can be hired at a lower cost to taxpayers than will actually be the case.

By pushing guaranteed pension payments into the future rather than making contributions as obgligations are accrued, policymakers pursue risky investment strategies in an attempt to meet their unrealistically high discount rate assumptions. State pension fund managers have increasingly invested in alternatives such as hedge funds and venture capital funds. These efforts to chase higher returns are not always properly hedged with the less volatile assets that they should be to fund guaranteed benefits.

NEEDED REFORMS

Today, many state and local pension funds lack the assets necessary to pay for these guaranteed benefits. As a result of flawed government accounting conventions, policymakers over the decades have failed to make the annual contributions needed to ensure that sufficient assets are available to fund the pensions of retirees now and in the future. Policymakers face difficult choices among cutting spending in other areas of their budgets, raising taxes, and paying retirees less than the benefit they have been promised.

To reach a more sustainable path, policymakers should take three key steps.

1. Assess Funding Using the Risk-Free Discount Rate

The first step toward fully funding public employee retirement benefits is to accurately calculate pension liabilities and contributions using the risk-free discount rate. Once policymakers know the correct amount required to fund guaranteed benefits, they can begin making the larger contributions needed.

2. Move from Defined-Benefit to Defined-Contribution Plans

Unlike public-sector workers, most private-sector employees fund their retirement savings in accounts like 401(k)s. While 401(k)s do not offer the guaranteed benefit promised by defined-benefit plans, defined-contribution plans do offer several advantages:

- *Flexibility*. With a 401(k) account, workers know how much they have saved, and they are not required to stay at their current job to receive the benefits—they can take these savings with them to a new job at any time.
- *Transparency*. Unlike defined-benefit plans, defined-contribution accounts require employers to make regular contributions, denying them the opportunity to engage in the opaque accounting or contribution deferrals seen in public-sector defined-benefit plans.
- *Comparability*. Because public-sector retirement benefits currently represent a large portion of public-sector compensation, compensation packages are difficult for workers to compare across the public and private sectors. If the public sector moved to the 401(k) model, workers could more easily compare compensation across different jobs.

3. Address Unaffordable Retiree Obligations

In some states and municipalities, reforming the retirement benefits for new employees may not be enough. In recent Chapter 11 bankruptcies, cities including Detroit and Central Falls, Rhode Island, have tested whether promised retiree benefits can be decreased. In each case, state courts upheld pension cuts, but future municipal bankruptcies could have different outcomes depending on the state constitution that governs bankruptcy proceedings. In cases where states or municipalities lack the tax base to meet their obligations, future retiree benefits or cost-of-living adjustments must be reduced. This situation demonstrates that public-sector workers and retirees have the most to lose from pension underfunding.

CONTACT

Bryce Chinault, 703-993-8148, bchinault@mercatus.gmu.edu
Mercatus Center at George Mason University, 3434 Washington Blvd., 4th Floor, Arlington, VA 22201

ABOUT THE AUTHORS

Eileen Norcross is a senior research fellow at the Mercatus Center at George Mason University. As program director for the Mercatus Center's State and Local Policy Project, she focuses on questions of public finance and how economic institutions support or hamper economic resiliency and civil society. She specializes in fiscal federalism and institutions, state and local governments and finance, pensions, public administration, and economic development.

Emily Washington is a policy research manager for the Mercatus Center at George Mason University. She manages the State and Local Policy Project portfolio. Her writing has appeared in *USA Today*, the *Christian Science Monitor*, *Economic Affairs*, and the *Daily Caller*.

ABOUT THE MERCATUS CENTER

The Mercatus Center at George Mason University is the world's premier university source for market-oriented ideas—bridging the gap between academic ideas and real-world problems.

A university-based research center, Mercatus advances knowledge about how markets work to improve people's lives by training graduate students, conducting research, and applying economics to offer solutions to society's most pressing problems.

Our mission is to generate knowledge and understanding of the institutions that affect the freedom to prosper and to find sustainable solutions that overcome the barriers preventing individuals from living free, prosperous, and peaceful lives.

Founded in 1980, the Mercatus Center is located on George Mason University's Arlington campus.

www.mercatus.org