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THE "OTHER" PENSION CRISIS

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In recent months, there has appropriately been substantial and growing attention to underfunding in state and local government pension plans. At the same time, there exists a similar (though smaller) set of financing risks in pension plans covered by the Pension Benefit Guaranty Corporation (PBGC), the federally chartered corporation established to insure employer-provided pension benefits. Several factors have contributed to underfunding in employer-provided pensions, including the recent recession, the opacity of asset/liability measurements, and the inadequacy of insurance premium assessments and funding rules, as well as the broader moral hazard and political economy factors that underlie these phenomena. Sound public policy is needed to help ameliorate employer-provided pension underfunding and to contain the risk of a potential taxpayer bailout of the PBGC insurance system.

RESEARCH FINDINGS

- The PBGC's latest annual report shows a net negative financial position for its insurance programs of more than $23 billion, of which roughly $21.6 billion is attributable to the PBGC's single-employer insurance program.[1]
  - This is nearly the largest PBGC deficit on record, falling just short of the record deficits in 2004 and 2005. PBGC's deficit has fluctuated from year to year, but throughout the last decade has remained significant. In each of the last eight years, PBGC's liabilities have been measured as being at least 15 percent larger than its assets.[2]
  - This persistent deficit is evidence that the recent financial crisis is not the sole reason for PBGC's financial shortfall. Even when the financial markets were at their recent peak, PBGC finances were on an unsustainable course, as evidenced by net deficits of more than $10 billion in each year from 2003 through the present.
- A number of factors have contributed to systemic pension underfunding, including:
  - Inaccurate measurements of plan assets
  - Inaccurate measurements of plan liabilities
  - Inadequate funding targets
  - Unfunded benefit increases
  - Loopholes and special preferences
  - Inadequate premiums
  - Limitations upon the national pension insurer
  - Inadequate disclosure
  - Barriers to funding up during good times
  - Moral hazard and political economy factors
  - Periodic contribution relief

1 Pension Benefit Guaranty Corporation, *2010 Annual Report* (Washington, DC: PBGC, 2010), 19 – 21 http://www.pbgc.gov/docs/2010_annual_report.pdf.

2 Ibid, 21.

- Many of the problems facing the employer-provided defined-benefit (DB) system arise from moral hazards common to all forms of defined-benefit pensions, including not only employer-provided pensions but also state/local systems as well as the federal Social Security program. In all of these systems, persistent underfunding reflects the temptation and opportunity to shift the risks of underfunding to third parties. Also prevalent are accounting methods employed to overstate funding levels.

- Three basic approaches to reform include:

    1. Empower the PBGC with the tools necessary to fill the shortfall in the national pension insurance system.

    2. Eliminate the PBGC and replace it with compulsory private insurance that would charge market rates to participants.

    3. Unless and until the federal government requires that the PBGC's financing risks be resolved via options #1 or #2, treat the shortfall for federal budgetary purposes as an obligation facing U.S. taxpayers. (This option could be thought of as the "taxpayer bailout" option. A federal taxpayer bailout of private sector pensions would be a grossly inequitable outcome. This third option is therefore not a recommendation for this policy course; rather, only that its potential consequences be disclosed for as long as there is a failure to take responsible action to prevent it. See research paper for more details)

- Regardless of the future structure of the PBGC, certain reform principles should be observed.

    - Limit asset "smoothing" to the extent practicable.

    - In liability measurements, limit "smoothing," use up-to-date mortality tables, and account accurately for worker behavior.

    - Eliminate special deals for politically favored industries.

    - Enforce prohibitions on unfunded benefit increases by underfunded plans.

    - Increase disclosure of funding information.

CONCLUSION

The substantial financing deficit of the pension insurance system will, one way or the other, exact a significant cost from some combination of employers, workers, or taxpayers. Prudent decisions will be required to balance the competing objectives of long-term funding adequacy and near-term sponsor viability. Public policy should aim at reducing underfunding within the sponsor-financed system and containing the risk of a taxpayer-financed bailout. This is best done by empowering the pension insurance system with the tools required to eliminate this underfunding or, as an interim fallback measure, fully disclosing the potential cost of our persistent failure to do so.

To view the complete study by Dr. Blahous, please visit http://mercatus.org/publication/other-pension-crisis.

ABOUT CHARLES BLAHOUS

Charles Blahous currently serves as one of the two public trustees for the Social Security and Medicare Programs. Specializing in domestic economic policy, his areas of expertise include retirement security, with an emphasis on Social Security and employer-provided defined benefit pensions, as well as federal fiscal policy, entitlements, demographic change, and health care reform.

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