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

RESEARCH SUMMARY

THE EXTENT AND NATURE OF STATE AND LOCAL GOVERNMENT PENSION PROBLEMS AND A SOLUTION

A number of US states and municipalities are facing dire fiscal crises, while many more have severely underfunded public employee pension plans. At the intersection of these two problems, the sustainability of many state and local government pension plans in their current form is highly doubtful. Benefit cuts for both current employees and current retirees may be necessary to save these plans from insolvency. However, the rigid legal protections many states have built around pension benefits provided to public employees mean that reforms will have to be voluntary for plan participants if chaotic failures are to be avoided.

A new study for the Mercatus Center at George Mason University examines both the overall financial condition of state and local pension plans and the legal impediments to pension reform. It argues that reform proposals that assume the federal government will bail out state and local pensions are politically and economically unworkable and unfair. Instead, it presents a two-pronged reform proposal: (1) require state and local authorities to disclose the financial condition of their pension plans to beneficiaries in plain language and using standardized conservative accounting assumptions, and (2) allow state and local governments to offer beneficiaries a choice between accepting the uncertain and risky future benefits originally promised or receiving a discounted lump-sum benefit right away.

To read the study in its entirety and learn more about its authors, Mercatus Senior Research Fellow Mark J. Warshawsky and Mercatus MA Fellow Ross A. Marchand, please see "The Extent and Nature of State and Local Government Pension Problems and a Solution."

BACKGROUND

Retirement Plan Trends and Differences between Public and Private Plans

- *Governments continue using defined benefit plans while private employers switch to defined contribution plans.* Under defined benefit plans, retirees receive a lifetime stream of retirement income from their employer, while under defined contribution plans, employees are

For more information, contact
Kyle Precourt, 703-993-8196, kprecourt@mercatus.gmu.edu
Mercatus Center at George Mason University
3434 Washington Boulevard, 4th Floor, Arlington, VA 22201

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

only entitled to the amount of money contributed to their individual accounts. While the use of defined benefit plans in the private sector has declined considerably in the past two decades, 83 percent of state and local government retirement plans are defined benefit plans.

- *Government workers receive higher compensation than private workers*. One study conducted by economists with the Bureau of Labor Statistics found that, when comparing employees of similar skill levels, state employees have 3–10 percent higher compensation than their private counterparts, while local employees have 10–19 percent higher compensation.

- *Public pensions have looser accounting rules than private pensions*. Public pension plans typically must follow standards developed by the Governmental Accounting Standards Board. These standards are much looser than the federal and private accounting rules governing private defined benefit plans.

The Dismal Financial State of Public Pension Plans

Several recent studies on state and local pension plans have found that a number of state pension plans are not sustainable and would require considerably higher contributions to remain solvent. For example, one study calculated that pensions in 21 states had funded percentages below 40 percent in 2009.

Another study found that, on average, state and local governments currently contribute 5.7 percent of annual revenue to their pension funds, but would need to contribute 14.1 percent to fully fund the programs. The average taxpayer would need to pay an additional $1,385 per year in taxes to close this gap. In the five worst states, the shortfall is more than $2,000 per taxpayer.

In addition, another study estimated that nearly a third of state pension plans will be exhausted within the next two decades.

Legal Rigidity of Pension Benefit Protections

Despite the dire situation many state and local pension plans are in, pension reforms are complicated by the legal protection most states grant to state workers' pension benefits. While some bankrupt municipalities have been able to reduce their pension obligations in federal court, most states have restrictions on doing so, and furthermore bankruptcy is not currently an option for states. The types of legal protections afforded to state employee pension benefits can be classified into four broad categories:

- *Gratuity*. Pension benefits are treated as an alterable form of payment, with few, if any, restrictions on what can be changed.

- *Contract*. Pension benefits can be changed, but only in certain limited circumstances.

- *Property*. Pension benefits are regarded as property, and can only be taken away with due process.

- *Constitutional*. Pension benefits are protected by the state constitution, meaning there is almost nothing states can do to alter pension benefits for employees.

In some states, these protections apply only to current retirees. In others, current workers' pension benefits are protected as well, further complicating reform efforts.

PROPOSALS FOR REFORM

A Federal Bailout Is Politically and Economically Unworkable and Unfair

Other pension scholars have made proposals for pension reform under the assumption that many state governments will soon be insolvent because of underfunded pension liabilities, and that a federal bailout of insolvent state and local pension plans will be inevitable. Proposals that include federal bailouts would lead to hundreds of billions of dollars in new federal spending and simply transfer the liabilities to the federal government without encouraging reform *before* pension plans become insolvent.

Such bailouts are unfair to the majority of states and municipalities that give modest retirement benefits to their employees and have responsibly funded these benefits, as well as to taxpayers who have responsibly funded their own retirements by themselves or through their employers. Moreover, recent precedents argue strongly against a federal government bailout. In the Detroit bankruptcy, retirees lost significant cash and healthcare benefits and no federal bailout was forthcoming. Owing to a recent federal law, thousands of retirees in multiemployer pension plans will soon be receiving notice that their benefits will be cut because their plans are approaching insolvency. In this case Congress explicitly rejected a federal bailout on a bipartisan basis.

An Alternative Proposal: Local Reform

The impending insolvency of many public pension plans is largely the result of poor governance and planning on the part of state and local officials. States, municipalities, and their pension plan beneficiaries and representatives should solve their problems from within rather than relying on the federal government. An alternative plan for reform should include the following features:

- *Reporting requirements*. All state and local governments should be required to file an annual report with the US Treasury that includes information on plan participant demographics and the funding status of their pension plans, using standardized conservative accounting assumptions, as is done in the private sector. Plans should be required to report this information to participants in plain language. Any states or municipalities that fail to comply should lose federal tax exemptions for the interest on their bonds.

- *Voluntary buyouts for plan participants*. State and local governments should be allowed, but not required, to offer retirees below age 80 and older workers a lump-sum buyout of their pension benefits. The buyout amount should be calculated by taking the present value of the accrued retirement benefits and discounting it by 100 percent less the funded percentage of the plan, and then adding 5 percentage points. Basing the discount on the plan's funded status would prevent the plan from becoming insolvent if many retirees opt

for the buyout, while the extra 5 percent would serve as an additional incentive for participants to take the buyout.

CONCLUSION

In the shadow of the pension insolvency crises looming over many state and local governments, taking action sooner rather than later will avoid painful, chaotic outcomes in the future. The proposal offered in this study presents a realistic reform option that would improve the financial status of state and local pension plans while giving retirees a chance for certainty and flexibility in retirement.