

STATE AND LOCAL GOVERNMENT PENSION FORUM
FEDERAL RESERVE BANK OF CHICAGO

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The Regional Perspective on Pension Issues

For many, the issue of public pensions is a rather arcane subject best understood by actuaries and public finance experts. It is my hunch that few in the general public are aware of the structure of public pensions or the magnitude of the growing funding gap. This is in many ways unfortunate. Public pension obligations are growing rapidly and beginning to reduce the ability of governments at all levels to fund other public programs. Consider just some of the following statistics:

- According to the U.S. Census Bureau, major public pension programs paid out \$78.5 billion in the 12 months that ended in September 2000. By the same period in 2004, pension payouts had grown by 50 percent to \$118 billion.
- State and local governments currently employ 14 million people, with an additional 6 million retirees. It is estimated that these workers and retirees are owed \$2.37 trillion by more than 2000 different state and municipal government entities.
- In 2003, states and municipalities contributed \$46.3 billion to pension plans, which was a 19 percent increase over 2002 levels. Pension funding has increased from 2.15 percent of all state and local spending in 2002 to 2.44 percent in 2003.
- Published government estimates suggest that the largest state and local pension funds faced a funding gap of \$278 billion in 2003. An analysis by Barclays Global Investors places the gap at closer to \$700 billion.

And if this weren't enough, fiscal liabilities will balloon when a new Governmental Accounting Standards Board (GASB) regulation is put into effect that will require state and local governments to recognize liabilities related to nonpension retiree expenses such as health care.

How did we get into such a mess and what can we do about it? To begin with, public pensions are not subject to the same ERISA rules that govern private pensions. This has made it easier to increase pension benefits to public sector retirees without identifying adequate funding. In addition, private pensions have been radically restructured. Only 24 percent of private firms continue to offer defined benefit programs where retirees are guaranteed a monthly income for the rest of their lives. In contrast, nearly 90 percent of public pensions are still defined benefit plans, and many of them include annual cost of living increases that increase liabilities even further.

Private firms have moved to defined contribution and 401(k) plans where retirement payouts are based on the employee and company contributions to the plan. This change in private firm behavior was perhaps best exemplified by IBM's announcement in January that it was ending its traditional pension program, which was the third largest among private employers. While the company will suspend contributions to its traditional program, it will offer employees an enhanced 401(k). A key issue to be investigated is whether defined benefit plans are the best mechanisms for providing state and local employee pensions. Do these plans better match the overall compensation structure for state and local government workers, or would a move toward defined contribution plans be appropriate?

Timing has also contributed to the problem. The stock market run-up at the end of the 1990s bolstered the balance sheets of almost all pension programs. In response, government contributions were often reduced or suspended. Swelling pension funds also encouraged governments to enhance employee benefits. With the onset of the 2001 recession, pension assets took a hit. In addition, many plans built in unrealistic investment return assumptions.

Pension issues are even more acute in many Midwestern states. In states with high population growth and personal income growth, future increases in tax revenues may help these states catch up on their pension imbalances. In addition, states with favorable demographics and younger state and local government employees will be slower to feel the bite of pension payouts. For most of the Midwest, however, population growth and demographics are not favorable. As a result, state and local pensions in the Midwest are much like the legacy costs that domestic automakers face. They are a financial burden that may hurt the competitiveness of these states and cities in the future.

How do we solve this problem? First, we need to have a better sense of the size of the pension obligation. More uniform accounting standards are likely needed to evaluate the true health of public sector pensions.

Second, it is likely that pension plans will need to be structurally changed, which includes identifying new funding sources and restructuring pension payouts. This will be no easy matter given that many state and local government pensions have strong legal protections that make restructuring current plans difficult if not impossible. For states with relatively weak balance sheets and large pension obligations, such as Illinois and Michigan in our district, restructuring could be particularly painful if it requires higher taxes or reductions in other government services to cover shortfalls.

Finally, solving the pension problem is more than an accounting exercise. Pensions must be recognized as part of any employee's total compensation program. Pensions in the private sector have been structured to meet firm and organization goals of retaining key staff members and building a productive workforce. The human resource management dimension is important to consider when redesigning pension programs to be actuarially sound and meet the needs of today's employees. For

private firms, the move to defined contribution and 401(k) programs recognizes the increased mobility of today's workforce. Pension portability better meets the needs of many of today's private workers. Pension programs need to reflect the needs of organizations in meeting their human capital requirements. No "one-size-fits-all" plan will be appropriate.

I look forward to today's discussion on this important topic. As a follow-up, we will publish a Chicago Fed Letter summarizing the findings and presentations from this forum. Thank you.