



# **Are Public Pensions Able to Break from the Path of Social Security and the Private Sector?**

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**A Forum on Public Pension Funding:**

***Defusing the Ticking Time Bomb***

Federal Reserve Bank of Chicago

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# Outline

- Basics of pension arrangements
  - Federal
  - State and local
  - Private
- Three dimensions
  - Magnitude of the problem
  - Financial resources
  - Institutional impediments
- Prospects and future options

# Basics of Pensions

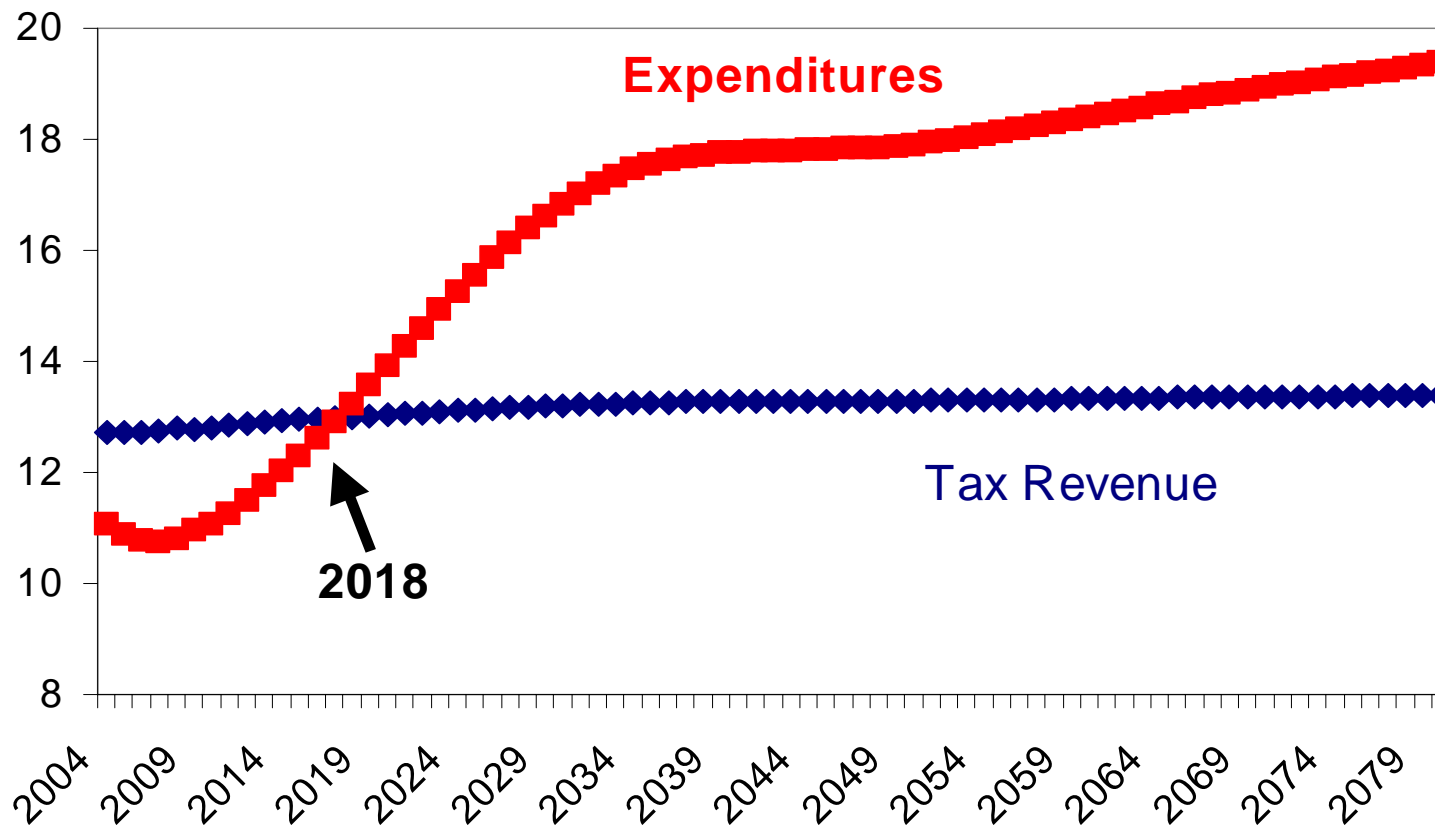
- **Federal**
  - Defined benefit
  - Pay-as-you-go
  - Infinite time horizon
  - No default, no bankruptcy
  - Future benefits not legally guaranteed (implied political promise)
- **State and local**
  - Largely defined benefit
  - Fully funded (with underfunding possible)
  - Long time horizon
  - Default unlikely, bankruptcy unlikely
  - Future benefits “guaranteed”
- **Private**
  - Defined benefit and defined contribution plan
  - Fully funded (with elements of de facto pay-as-you-go)
  - Limited time horizon
  - Default and bankruptcy possible with PBGC partial backup
  - Future benefits uncertain

# Magnitude of the Problem

- Federal
  - Huge future liability
    - \$38 trillion before new Medicare drug benefit
    - 362 per cent of GDP

Note: Measures of magnitude of problem are not strictly comparable

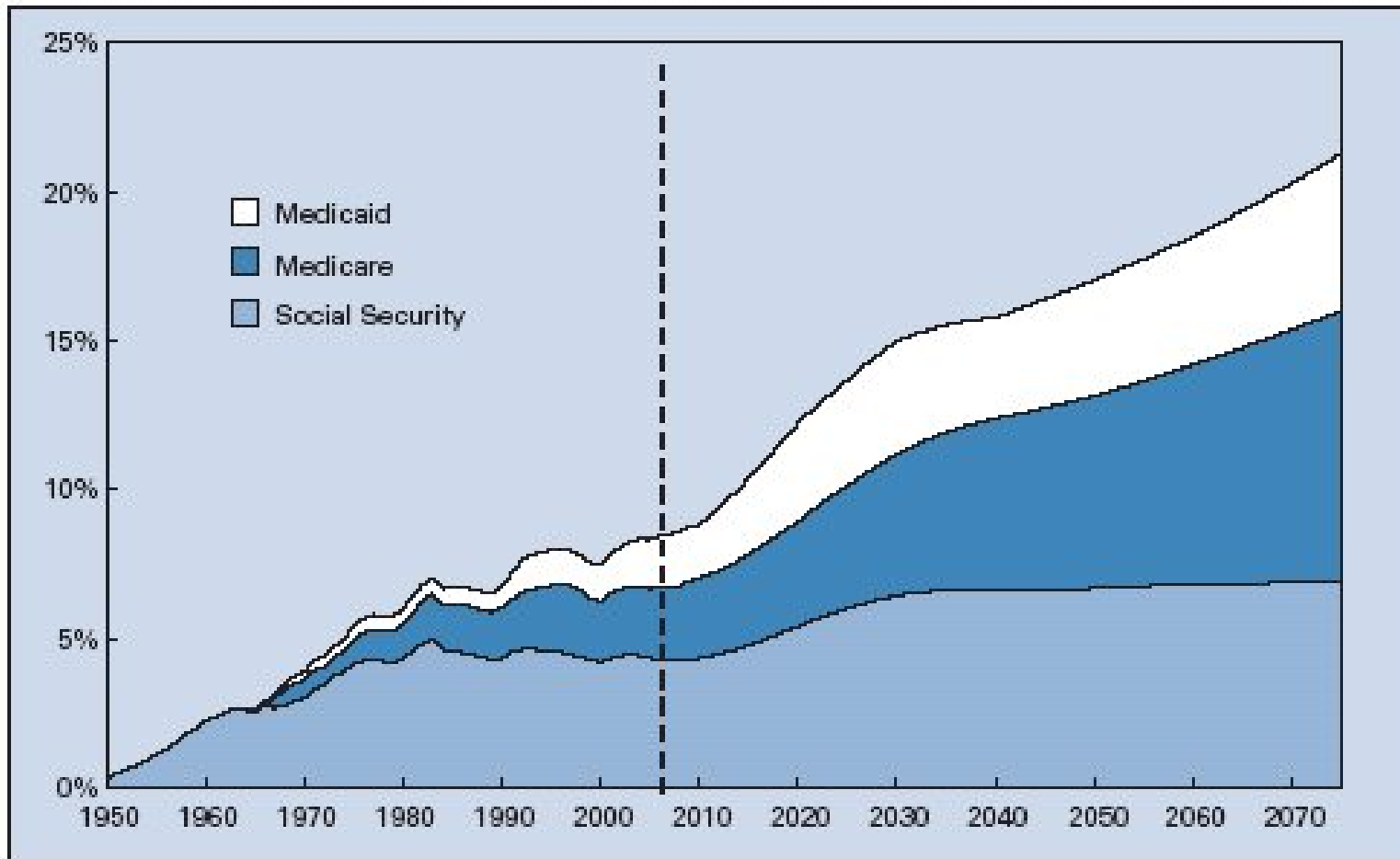
# Social Security Finances as % of National Covered Earnings



From: Jeffrey Brown  
University of Illinois

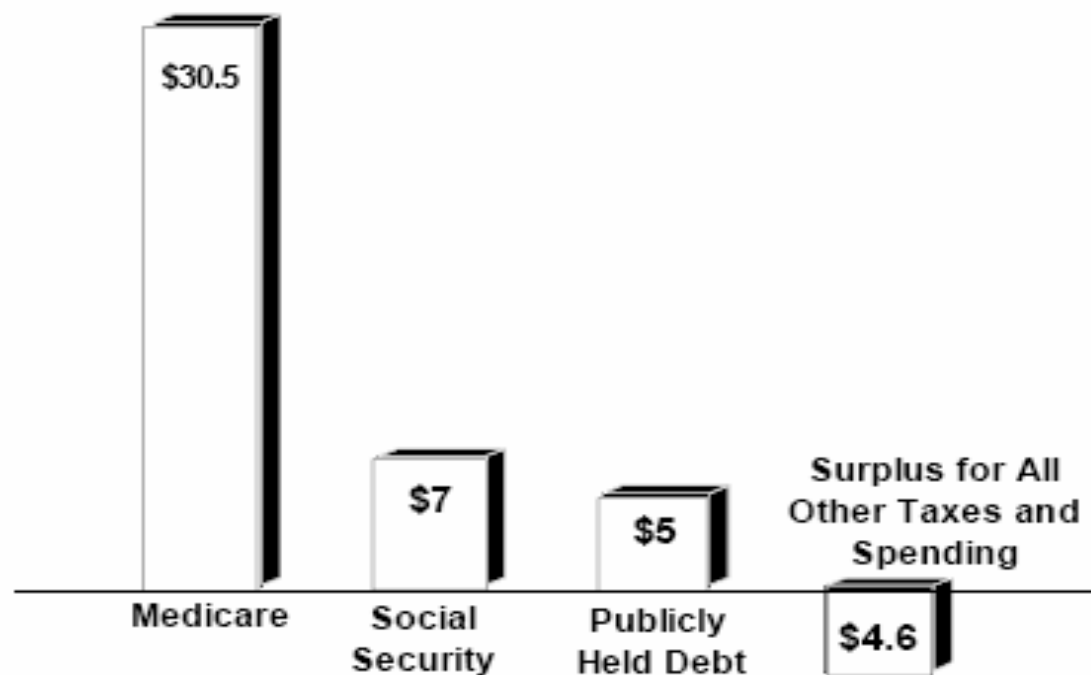
# Social Security, Medicare, and Medicaid Outlays as a Percentage of GDP

## Fiscal Years 1950-2075



The Incredible Shrinking Budget for Working Families and Children,  
C. Eugene Steuerle, Urban Institute, December 2003

## Federal Obligations (present value of obligations less revenue) in trillions of dollars



Note: As of 2002 Fiscal Year End.

Source: Jagadeesh Gokhale and Kent Smetters.

# Magnitude of the Problem

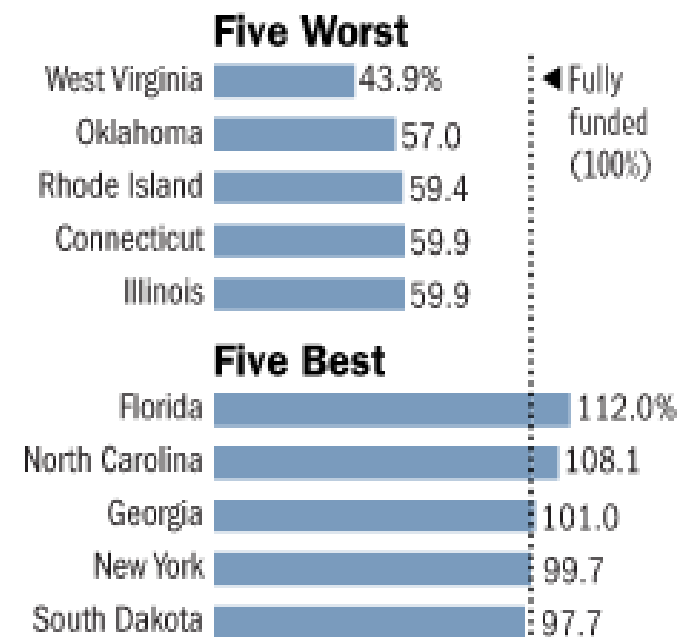
- State and Local
  - \$700 billion estimated unfunded liability (BGI)
  - 6.0 percent of GSP
  - \$284 billion (state only) (S&P)
  - 2.4 percent of GSP
- Illinois (state only)
  - \$38.6 billion unfunded liability (CGFA)
  - 6.0 percent of GSP
  - 147 percent of general fund revenues

Note: Measures of magnitude of problem are not strictly comparable

# Wide Variations in State Funding

## Falling Behind

Public pension funds are under-funded by about \$284 billion nationwide. States with the best and worst pension funding in fiscal 2004, by funded ratio (ratio of fund assets to liabilities):



Source: Standard & Poor's

# Magnitude of the Problem

- Private Sector
  - \$450 million estimated unfunded liability (Lowenstein)
    - 4.3 percent of GDP
  - Insurance value of PBGC Liability--\$141 billion (20 years)
    - 1.6 percent of GDP

Note: Measures of magnitude of problem are not strictly comparable

# CBO's Estimate of PBGC Liability

## Summary Table 1.

### PBGC's Past and Projected Costs for Single-Employer Plans

(Billions of dollars)

	Market Value <sup>a</sup>
Accumulated Deficit, as of September 30, 2004	23.3
Prospective Net Costs	
Over 10 years	63.4
Over 15 years	95.7
Over 20 years	118.6
Total	
Over 10 years	
Over 15 years	
Over 20 years	

Source: Congressional Budget Office based on information from the Pension Benefit Guaranty Corporation.

- a. Estimated price that a private insurer would charge, in addition to current premiums, to accept the obligations arising from terminations over the indicated time period.

CBO Paper

SEPTEMBER 2005

The Risk  
Exposure of  
the Pension  
Benefit Guaranty  
Corporation

# Resources Available to Meet Problem

- Federal
  - Monetary powers
  - Power to tax
- State
  - Power to tax (more limited than federal)
  - Other revenues (fees, tuition, etc.)
- Private
  - Revenue from operations
  - PBGC

# Institutional Constraints

- Federal government
  - Ultimately a difficult political issue that must be addressed
  - Recent development are not encouraging, but pressure will mount for a solution
  - Two Quotations:
    - "Lord, give me chastity and self restraint, but not yet." St. Augustine (late 4th century)
    - "If something cannot go on forever, it will eventually end." Herbert Stein (late 20th century)

# Institutional Constraints

- State governments
  - Pensions have been used as a means for the state to avoid hard choices
    - Implicit borrowing without the usual constraints
    - Pension underfunding is often a manifestation rather than the cause of state fiscal problems
  - Moral hazard issues
    - Implicit or explicit guarantee of benefits
    - Distorted incentives for politicians and employees
    - Analogy to saving and loan crisis

# Institutional Constraints

- State governments (continued)
  - Political impediments
    - Issues of corruption
    - Investment limitations
      - Illinois and Sudan (Darfur)
      - Directed Illinois investment?
      - Predatory lending issues (Speaker Madigan)
      - Pressures to hire certain managers
  - Are board's well constituted to reach investment objectives?
    - Political risk
    - Long term horizon

# Institutional Constraints

- Private sector
  - Moral hazard issues
    - Implicit or explicit guarantee of benefits with PBGC
    - Only applies to firms in distress
  - More flexibility in limiting benefits
  - DB vs. DB

# Future Prospects and Options

- Rules from Douglas Holt-Eakin (former CBO Director) about dealing with social security and health care at federal level
  - A reasonable response will inflict pain
  - All programs and revenue sources must be on the table
- Both state and local and private problem can be addressed given the political will
- Federal problems must be addressed and cannot be avoided

# Future Prospects and Options: State and Local

- The basic answers:
  - Continuing revenues must be increased and/or
  - Significant cuts must be made in many programs, not just pensions
  - Move to DC from DB
    - Will not solve short term problems
    - Might be considered for dealing with longer term issues
  - Giving up—moving to a pay-as-you go system
    - Extremely costly—20+ percent of payrolls vs. 10 percent
- Do states have the political will to do any of these appropriately?
- Will they revert to similar bad behavior in the future?