

Chicago Fed Letter

State and Local Government Public Pension Forum: A conference summary

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As growing numbers of their work force approach retirement age, state and local governments are taking a hard look at their pension funds to see if they are prepared for this exodus. This one-day conference brought together policymakers and experts to weigh the state of these funds.

The future of state and local government public pension systems and related health care liabilities was the subject of a conference held at the Federal Reserve Bank of Chicago on February 28. The conference was cosponsored by the Bank, the Civic Federation, and the National Tax Association and brought together pension experts from law, accounting, and economics to discuss public pension dynamics and future liabilities.

Lance Weiss and Tim Phoenix from Deloitte Consulting began the program by discussing the influence that pension structure and benefits can have on recruiting and retaining talent in the public sector. While public sector leaders often recognize that an aging government work force is a significant issue, they are often at a loss on how best to manage pension obligations to meet the needs of both government employees and taxpayers. Public sector demographics suggest that a large portion of government workers are approaching retirement age, and this could lead to a significant talent gap. To manage this issue, Phoenix suggested governments look at their work force supply and demand strategies to ensure that they have the appropriate knowledge capital to meet their needs. The supply strategies include targeted strategies for improving attraction and recruitment, as well as

realigning retirement and reward programs to retain and potentially extend the longevity of key employees. They also include better talent development programs and transferring knowledge from experienced workers before they retire, as well as investigating flexible employment options. On the demand side, various productivity enhancing strategies are key. These include expanding use of automation, investigating outsourcing, and providing self-service for customers.

Lance Weiss followed with an overview of pension fund dynamics. Weiss stressed that the public pension environment has changed radically, driven by new accounting requirements, such as Government Accounting Standards Board (GASB) No. 45, that force governments to recognize health care and other nonpension expenses and changing expectations for the role of the employer in providing retirement benefits. These nonpension expenses are referred to as “other post-employment benefits” (OPEB). The era of employer paternalism is being replaced by one of employee empowerment, with the risk of saving for retirement shifting to the employee. Weiss suggested that states have two basic options for addressing a pension funding shortfall. First, they can cut costs by reducing basic and/or ancillary plan benefits, or trim administrative expenses.

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Second, they can increase investment returns or find alternative funding sources. They can defer costs by changing funding policies, changing actuarial assumptions or funding method, or changing the asset valuation method. Weiss stressed that deferral strategies will do little to address fundamental drivers of pension fund solvency. Weiss concluded that any strategy to fix pension shortfalls or reduce benefits must recognize the sensitivity many government employees have about their retirement benefits.

demographics, stock market declines in 2000 and 2001, and the enhanced pension benefits during the strong revenue growth years for many states in the 1990s. The aggregate funded ratio for state governments went from 100% in 2000 to 84% in 2004. Noting that pension and OPEB obligations will be with state and local governments for some time to come, he suggested that policies will likely need to address both the asset and liability side of the balance sheet. For example, the state of Oregon undertook

requirements, reductions in benefit coverage will also be considered.

Joseph O’Keefe of Fitch Ratings noted some other considerations pressuring public pensions. First, attempts to change benefit levels are becoming increasingly critical in any labor negotiations, and attempts to shift from defined benefit to defined contribution pension programs are frequently met with resistance from public employee unions. Second, new state employees are often receiving less generous pension options than vested employees. Finally, many actuarial studies suggest that contribution rates are lagging benefit costs, suggesting that the problem will become worse before it improves. O’Keefe noted that many governments are increasingly looking for external financing options. In particular, pension bonds have been growing in popularity. He stressed that while issuing bonds is often an appropriate strategy, it has some distinct risks. Since it is based on an arbitrage strategy of capitalizing on higher investment returns from the bonds’ assets relative to the cost of the issued bonds, market timing is critical. In addition, in using bonds, the government takes a “soft” debt (i.e., one that it has flexibility in funding) and turns it into a “hard” debt that requires meeting annual defined payouts.

Michael Moskow, President and CEO of the Chicago Fed, offered his perspective on pension issues and their regional implications. To begin, Moskow noted that public pensions are not subject to the same ERISA (Employee Retirement Income Security Act) rules that govern private pensions. This has made it easier to increase pension benefits to public sector retirees without assuring adequate funding. In addition, private pensions have been radically restructured. Only 11% of private firms continue to offer defined benefit programs in which retirees are guaranteed a monthly income for the rest of their lives. Nearly 90% of public pensions are still defined benefit plans, and many of them include annual cost of living increases that increase liabilities even further. In contrast, private firms have moved to defined contribution plans and 401(k) programs where retirement payouts are based on the

States with younger state and local government employees will be slower to feel the bite of pension payouts.

Richard Ciccarone of McDonnell Investment Management moderated a panel of major rating agencies. Ciccarone noted that, from the perspective of an institutional investor, the key questions in the public finance market are: Do the ratings provided by the rating agencies provide investors with sufficient warning of deteriorating financial condition? Second, do bond prices reflect the risk of the issuer? In both cases, Ciccarone suggested that even within the same rating category, the issuing governments often appear to have widely differing underlying financial strength. For example, public debt instruments rated as AA include those of states such as Illinois, West Virginia, Rhode Island, and Connecticut. All of these states have pension funds with funding ratios below 75%, and yet there is little effect on their debt rating. He also noted that investors have been willing to purchase riskier bonds, such as the Illinois pension bond offering of 2004, without requiring the bonds to pay a premium, suggesting that the market does not do a better job at pricing risk. He concluded that some of this might be due to bond insurance that often makes the underlying quality of the issuer immaterial to the investor.

The first of the presentations by the rating agencies was John Kenward of Standard & Poor’s. Kenward noted that the deterioration in public pension solvency has been very rapid and driven by the confluence of unfavorable

a sweeping reform of its pension program that included closing the defined benefit program to new hires. It also sold \$2 billion in pension obligation bonds and created a new hybrid program for new employees. Finally, Kenward stressed that Standard & Poor’s will continue to examine management, financial condition, and debt level, as well as macroeconomic factors, in determining governments’ creditworthiness.

Paul Nolan of Moody’s Investor Service spoke about OPEB exposure. He stressed that, in the long term, the OPEB requirements will improve the financial transparency of government but will create several short-term headaches. The GASB No. 43 and No. 45 will require governments to go from a pay-as-you-go system for funding nonpension retiree benefits (largely health care) to a structure in which future liabilities must be reflected on the government’s accounting statements. In assessing the ability of any particular government to meet its OPEB liabilities, Moody’s will look at the size of the liability relative to potential revenues and to peer governments. Like Standard & Poor’s, it does not anticipate wide-scale credit reductions, assuming that most governments will have a reasonable plan for meeting liabilities. Nolan anticipates that governments will begin to prefund health care expenses as well as consider issuing OPEB bonds to meet obligations. Depending on the contractual

employee and company contributions to the plan. A key issue is whether defined benefit plans are the best mechanisms for providing state and local employee pensions, or whether a move toward defined contribution plans would be appropriate.

Moskow suggested that pension issues are even more acute in many midwestern states. In states with high population and personal income growth, future increases in tax revenues may allow these states to 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. Unfortunately for some of the Midwest, state and local pensions are similar to the legacy costs that domestic automakers face. They are a financial burden that may hurt the competitiveness of these states in the future.

To address this issue, Moskow observed that 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. Beyond this, it is likely that pension plans will need to be structurally changed, including 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. 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 have been structured to meet firms' and organizations' goals of retaining key staff and building a productive work force. The human capital dimension is an important consideration in redesigning pension programs of today's employees. For private firms, the movement to defined contribution and 401(k) programs recognizes the increased mobility of today's work force. Pension portability better meets the needs 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.

Next, Fred Giertz of the University of Illinois and the National Tax Association contrasted the condition and structure of state and local government pensions to those of social security and private pensions. The magnitude of the financial liability of the programs is significantly different. The future liability for Social Security and Medicare is \$38 trillion, which represents 362% of gross domestic product (GDP). The high-end estimate of state and local pension funding liability is at \$700 billion or 6% of total gross state product (GSP). Even in states with particularly acute problems, such as Illinois with an unfunded liability of \$38 billion, this represents only 6% of that state's GSP. Private sector pension exposure is estimated at \$450 billion (4.3% of GDP), and some of that exposure is limited by the Pension Benefit Guaranty Corporation (PBGC).

Giertz next turned to resources available to meet the problem. The federal government has the broadest resources with both broad monetary and tax powers. While states have reasonably broad taxation powers, they are limited by interstate competition in exercising them too aggressively. They also can increase revenues through fees and other non-tax sources. Private pension resources must draw from company operations or, in the case of a bankruptcy, the PBGC. Giertz noted institutional constraints that might interfere with appropriate actions. For Social Security, solving the problem has been likened to the third rail of American politics. There is no solution that will not cause significant pain to a given constituency, making it easier to simply defer the problem. State governments similarly have used pension underfunding for implicit borrowing to fund other programs. As such, it is often the manifestation rather than the cause of state fiscal problems. Giertz noted that pensions are often targets of political influence. This can range from outright corruption to more subtle limitations that reduce returns by raising administrative costs to limiting investment options.

Giertz concluded that political will is the key to addressing state and local pension shortfalls. This is a large but manageable problem; however, to ensure that state and local governments do not revert to their old ways, some structural reforms to pension administration may be worth examining.

James Spiotto of Chapman and Cutler provided a legal perspective on pension fund issues. A key question is whether pensions are a vested right of the employee or a voluntary gratuity provided by the employer. As a vested right, many governments include nonimpairment clauses that make it difficult to restructure pension or OPEB benefits if the plan is under financial duress. However, there are varying levels of protection, ranging from strict constitutional rights to general statutory provisions, that might allow for some renegotiation of benefit levels in light of adverse conditions affecting the pension fund.

Spiotto noted that the difference between "unwillingness to pay" and "inability to pay" is important in understanding how governments should deal with their pension issues. Governments with an inability to pay face a major public finance problem that will require restructuring

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government programs and revenues to meet their obligations. This might even lead to governments seeking bankruptcy protection from the court. Spiotto noted that states cannot go bankrupt; however, they can repudiate debt. Local governments have more options. They can file for a Chapter 9 bankruptcy that allows adjustment of debt or debt payments; however, this requires state authorization. Courts have permitted the alteration of pension benefits under Chapter 9 filings. Spiotto concluded that pension obligations can best be met when funding is clearly identified (and even specifically dedicated) to meet obligations.

Hank Sheff of the Association of Federal, State, and Municipal Employees (AFSME) Council 31 offered organized labor's perspective on pension funding. Sheff noted that public employee unions strongly favor defined benefit programs. Not only do these better meet the needs of public employees, but Sheff argued that they are more cost effective to operate. He noted that pensions are more critical to many public workers, given that nearly one-quarter of them do not receive Social Security benefits.

Sheff noted that many public pension plans are in fact well funded but that only those with the greatest problems make the national media. Illinois, for

example, has one of the most comprehensive problems that can largely be blamed on systematic underfunding of pension liabilities over an extended period of time. Underfunding pensions allowed the state to mask other fiscal problems, including a tax structure that has failed to grow fast enough to meet state obligations. While Illinois has adopted a plan to restore pension solvency, Sheff noted that it requires very steep state contributions that would reach almost 23% of total payroll by 2011.

Sheff concluded that the Illinois pension's future looks bleak unless new taxes are considered. For public employees, solutions that would diminish benefits for future workers or cut state programs would be draconian solutions.

Lise Valentine of the Civic Federation presented recent research on the structure of pension boards. Valentine suggested that pension boards should be structured to be free of political influence and focus entirely on safeguarding the assets of the fund through prudent investment and effective management. In particular, pension boards should not engage in advocating for a particular group of stakeholders.

Valentine's research suggested that best-practice states require the participation of citizen members who are not fund

beneficiaries and/or independent financial experts. Examples include the Maryland State Retirement System, the Texas Teachers System, and Virginia's state program. These programs balance employee and management representation and have a structure that requires independent citizen participation. They also have financial experts and focus on optimal stewardship for fund assets. Valentine urged that Illinois pension funds adopt such a structure.

Conclusion

Conference participants generally concluded that pension and OPEB liabilities will prove to be a major fiscal challenge for state and local governments for some time to come. While the depth of the problem will vary from place to place, these liabilities will pressure government balance sheets and require many governments to take a hard look at available revenues and expenditures to meet the retirement needs of their employees and still maintain government functions.

The Chicago Fed will continue to investigate pension issues. Please visit the conference website at www.chicagofed.org/news_and_conferences/conferences_and_events/2006_government_pension_agenda.cfm to download conference presentations and share ideas on our pension blog.