The Pending State Pensions Crisis

September 26, 2012

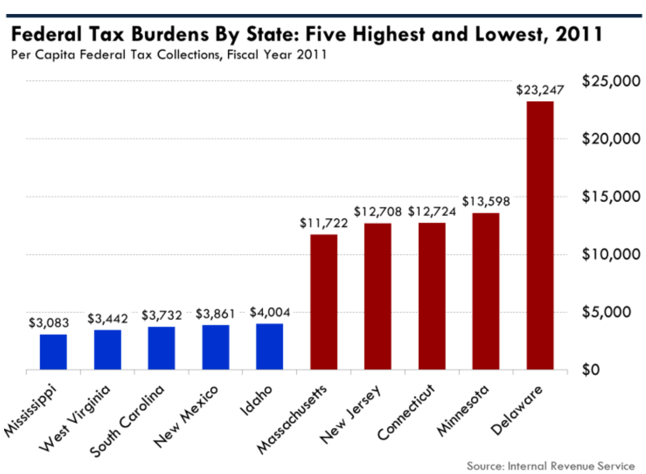
The Inevitable Requests for State Pension Bailouts

By all measures, state and local government employee pension funds are significantly underfunded. By standard accounting methods, some state pension funds will run out of assets within as little as five years.[1] When this happens, states will have to use general government tax revenue to pay their pension benefits, which in most cases hold the highest priority of payment. Depending on states' constitutions and their individual policy choices, maintaining full pension benefits without sufficient pension fund assets will require tax increases, cuts in government services, or additional debt issuance. When these austerity measures prove too severe for states and localities to handle – politically or economically – governors and mayors will inevitably come to Washington requesting federal bailouts. And despite the massive federal debt and fiscal imbalances, it will be hard for Washington policymakers to deny sympathetic retired teachers, police, and firefighters after a previous Congress bailed out Wall Street and the U.S. automakers.

By standard accounting methods, some state pension funds will run out of assets within as little as five years.

When the states with the worst pension systems come knocking at Washington's door for a bailout, it will ultimately be taxpayers in more prudent states who will pay for the recklessness of the negligent states.

Already, federal grants to the states result in significant income redistribution. For example, the five states with the highest level of per capita federal grants receive nearly three times as much as the five states with the lowest amount.[2] And the five states with the highest per-capita federal tax burden pay more than four times as much in total federal taxes as the five states with the lowest burden.[3]



If the states with the most troubled pension funds come to Washington for a federal bailout, the burden of this bailout will be borne disproportionately by states that already pay the highest share of per capita federal taxes and states with relatively sound pension systems.

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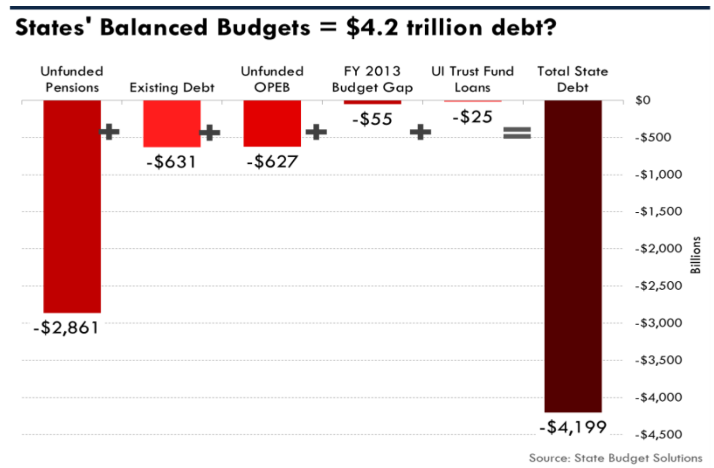
(Continued on the next page …)

As more and more states come to the federal government for bailouts, taxpayers in fiscally sound states will grow increasingly frustrated and hostile toward the fiscally reckless states. This tension could lead to a severe divide between the fiscally responsible and irresponsible states, just as we are seeing occur in the Eurozone today.

The only way to prevent a federal bailout of state pension funds is for states to take action today to curb their underfunded and unsustainable pension systems. Enacting pension reform will not be easy, particularly in the states with the greatest unfunded liabilities, but if a federal bailout remains on the table, states will have no reason to impose fiscal discipline.

The Problem with State Finances

Despite balanced budget amendments in 49 states, the grand total of state debt is $4.2 trillion.



Forty-nine of the fifty U.S. states have balanced budget requirements, meaning that annual expenditures are not supposed to exceed annual revenues. But with expenditures and revenues being loosely defined and special bond issuances available for certain deficit spending, annual state spending is rarely confined to annual tax revenues. Total existing state debt amounted to $631 billion in 2011. But on top of that is another $2.8 trillion in unfunded pension benefits, at least $627 billion in other post-employment benefits (OPEB), such as health care, $55 billion in FY 2013 debt and $25 billion in Unemployment Insurance Trust Fund loans, bringing the grand total of state debt to $4.2 trillion.[4]

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The largest component of states' de facto deficit spending is unfunded pension liabilities for public employees, as well as unfunded liabilities for OPEB. While balanced budget requirements make it difficult for politicians to appease public employees and the unions that represent them with direct wage increases, it is relatively easy to grant higher compensation in the form of future pension and other post-employment benefits. Such irresponsible and unfunded benefit promises have little to no effect on current expenditures, but they severely restrict future state and local governments in their ability to provide essential services without growth-stifling tax hikes.

Many states and localities have regularly skipped or underfunded contributions to pension plans.

What's more, many states and localities have regularly skipped or underfunded contributions to pension plans. Over the past five years, state and local governments have underpaid actuarially required pension contributions by more than $50 billion.[5] The worst culprit of all, Illinois, has underpaid its pension contributions to the tune of $28 billion over the past 15 years.[6] This $28 billion has, no doubt, given way to other government spending while the pension fund itself has depleted to only 44% funding in

2009 according to the state's own accounting standards, and less than 30% funding by conventional accounting standards.[7, 8]

Pension Protections and the Magnitude of Pension Liabilities Make Bailout Requests Inevitable

Reforming state and local pension systems to make them solvent for the long run is extremely difficult, both because of the powerful unions that oppose anything that might reduce pension and other employee benefits as well as the strong protections afforded to many state pension systems – sometimes protected not only in law but in the state constitutions themselves. In most cases, state constitutions prevent changes to public employee pensions for existing employees and retirees, and pension benefits take precedence over virtually all other forms of spending, meaning retired teachers receive their pension checks even before current teachers receive their paychecks.

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An analysis by Professor Joshua Rauh of Northwestern University found that, among the states with pension plans that will run dry by 2018, paying public pension benefits to retirees in the year after each fund runs dry will consume an average of 34% of those states' 2008 tax revenues.[9] That means less than two-thirds of all state tax revenues would be left over to finance education, law enforcement, public safety, infrastructure, welfare programs, and all other state spending. While some states, like Ohio and Rhode Island, have about a decade before their public pensions are projected to run dry (2023), their pension payments due in the following year amount to a whopping 72% and 67% of each state's respective 2008 tax revenues.[10]

Without reform, pension funds will begin to run dry and paying out legally required benefits will crowd out other state and local spending, necessitating the need for greater deficit financing. But pension depletions would draw attention to states' poor fiscal situations and cause investors to become wary of purchasing such debt, thus causing interest rates to rise. Pension woes have already been the source of credit rating downgrades. Illinois, for example, was recently downgraded by S&P from an A+ credit rating to A because of "weak pension levels and lack of action on reform measures," adding a negative outlook to what is already S&P's second lowest-rated state (California is the S&P's lowest).[11] And Moody's has threatened to further downgrade Illinois' credit rating (already Moody's lowest rated state) as the state approaches a level where institutional investors will no longer be comfortable putting their money in Illinois bonds. Illinois is already estimated to pay a 150 basis point premium on its debt versus other AAA-rated state debts.[12] Failure to enact significant fiscal reform will increase this premium.

Without the ability to borrow funds at reasonable rates, states and localities would have no choice but to enact significant tax increases and spending cuts. Tax increases – especially of the magnitude necessary to cover pension liabilities – will drive successful businesses and individuals to other states, leaving far less in new revenue than projected. And spending cuts – exempting pension and other employee benefits – could be so large that states are no longer able to provide even the most basic of services to their citizens. And who, besides the public retirees receiving pension checks, will stick around in a state that heavily taxes its citizens without providing even the most basic of services?

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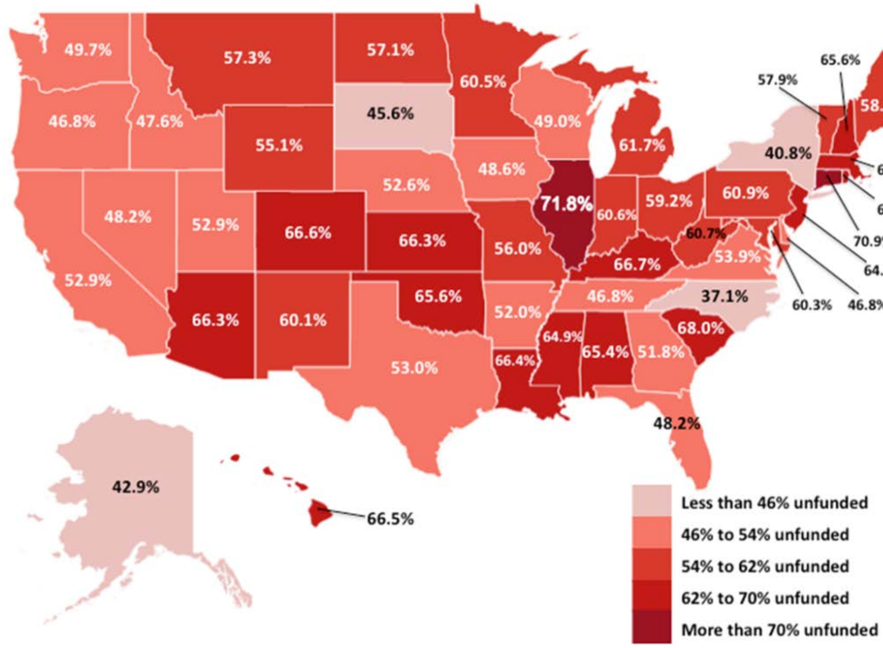
State Pension Plans Unfunded Liabilities as a Percent of Total Liabilities[13]



The size of the coming crisis is so large that reasonable tax increases and spending cuts will not solve the problem.

Absent exceptional market returns over the next decade (something that is unlikely given the troubled fiscal outlook of much of the developed world), many states will confront a severe public pension crisis. The size of the coming crisis is so large that reasonable tax increases and spending cuts will not solve the problem. And if public employee unions continue to refuse any sort of reform that would bring public sector pensions more in line with private sector retirement systems, the states will inevitably come knocking on the federal government's door for a bailout. And whether it is sympathy, cronyism, fears of financial contagion, or a desire to further increase the size and scope of the federal government, Washington policymakers will no doubt find it difficult to say no to saving the pensions of retired teachers and firefighters after a past Congress bailed out the big U.S. banks and automakers.

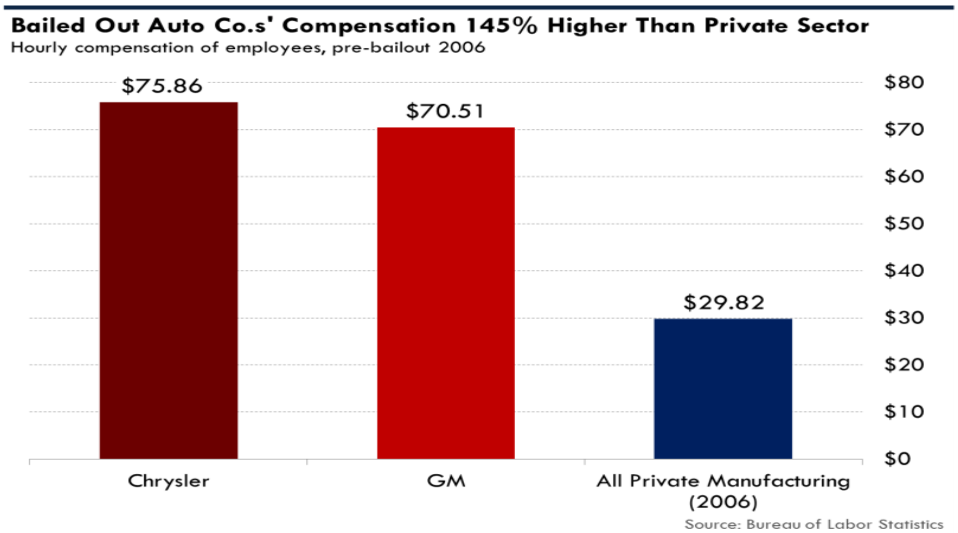
What States and Other Federal Bailout Recipients Have in Common

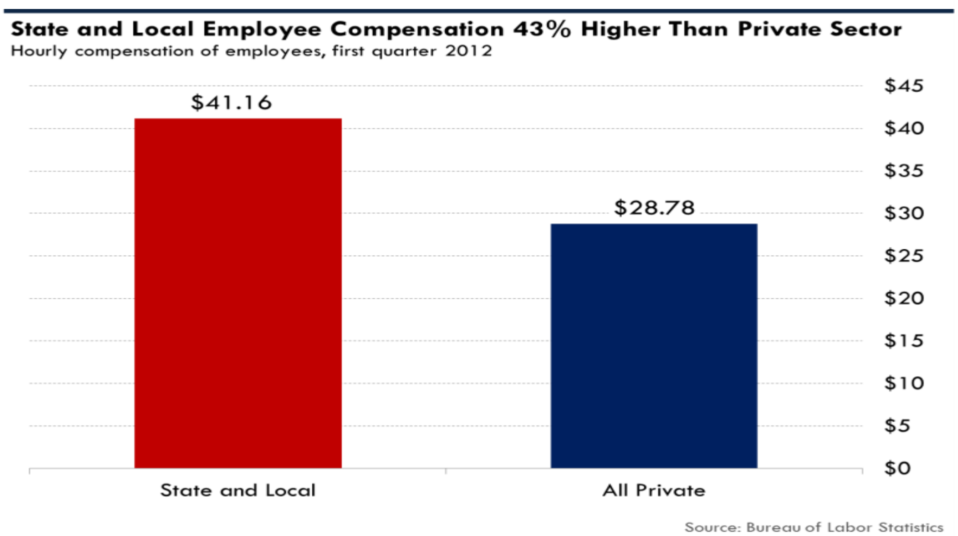
State and local pension funds are irresponsibly projecting unrealistically high rates of return on their pension funds while providing above-market compensation.

In many ways, the state and local pension funds are acting much like the big banks and automakers before they were bailed out. Just as the big banks were knowingly engaging in risky behavior and just as Chrysler and General Motors (GM) were conceding unsustainable pay and benefits to their unionized workers, some of the most fiscally troubled states are doing the exact same things. They are irresponsibly projecting unrealistically high rates of return on their pension funds while providing above-market compensation – often in the form of future promised benefits – to their employees.

What is known as the "auto bailout" was, in fact, a union bailout for the United Auto Workers (UAW). An analysis by the Heritage Foundation found that the $80 billion that the federal government spent on the auto bailout would have actually produced a positive return for taxpayers were it not for the preferential treatment afforded to the UAW in the Chrysler and GM bankruptcy proceedings.[14] Taxpayers are estimated to lose $20 billion to $22 billion from the auto bailout, but the preferential treatment given to the

UAW – the difference between what the UAW received versus what it would have gotten if it had been treated equally to other unsecured creditors – amounts to $26.5 billion.[15] So for the taxpayers' cost of more than $20 billion, employees in the United Auto Workers' union were protected from having to accept the kinds of sustainable salaries and benefits that non-union workers in America's profitable auto companies enjoy. Meanwhile, Chrysler's unsecured creditors suffered a 100% loss and GM's unsecured creditors took a 73% haircut.[16]





Just as the UAW, with its ability to secure excessive pay and lavish retirement benefits, prevented the auto companies from running sustainable businesses, the unionization of state and local government employees is likely to be the downfall of state and local finances. Out of political self-interest, state and local politicians have given public sector unions much higher wages and more generous benefits than their private sector counterparts, all at the expense of current and future taxpayers. In the first quarter of 2012, state and local employees received 43% more in total compensation compared to their private sector counterparts. It is not sustainable to have public servants making more money than the public paying their salaries.

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Yet, sustainable or not, public employee unions, such as the Chicago Teachers Union, refuse to settle for any sort of reform that would bring their compensation even slightly more in line with the private sector workers who pay them. The Chicago Teachers Union requested a 30% pay increase on top of what are already among the highest teacher salaries in the nation (the average salary is well over $70,000 excluding benefits). But what are really excessive are Chicago teachers' pensions. Even though the Chicago teachers' pension fund is only 32 percent funded, the average pension benefit for a teacher retiring with 30 or more years of service in 2011 carried a whopping $1.6 million cash value (the average annual benefit was $77,496, compared to the maximum Social Security benefit of $30,156). [17] To accumulate a retirement account sufficient to purchase an annuity similar to the Chicago teachers, the average private sector worker would have to contribute nearly $15,000 per year for 30 years.[18] And yet, despite all the taxpayer dollars that support Chicago teachers with the highest salaries in the country and $1.6 million pensions, the Chicago Teachers Union does not want teachers to be held accountable for their students' test scores (the dropout rate for students entering a Chicago public high school is 40 percent).[19] Such excessive compensation and lack of accountability are unheard of in the private sector.

The Chicago Teachers Union is just one example of Illinois' much larger problems. The state is set to spend more than $1 billion in FY 2013 just on retired employees' health care benefits.[20] According to the most recent data from 2010, Illinois' spending on retirement benefits consumed more than three-fourths its total income tax revenues, and amounted to more than the state spent on education (state retirement benefits totaled $7.6 billion, income tax revenues were $9.9 billion, and education spending was $7.4 billion). When such a sizeable and growing share of all revenues is being spent on the retirement benefits of past government employees, there is less and less left to support current government functions.

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States Are Already Heavily Reliant on Federal Funds

In 2011, federal grants-in-aid to state and local governments topped $600 billion.[21] This aid amounted to almost 30% of states' total revenues, 16.8% of total federal outlays, and 4.1% of U.S. GDP (in comparison, Social Security equaled 4.8% of GDP, and Medicare, Medicaid, and Chip equaled 5.5% of GDP).[22,23]

Policies such as the Patient Protection and Affordable Care Act ("Obamacare") will exacerbate states' fiscal crisis by adding 16 million Americans to the Medicaid and Children's Health Insurance Program (CHIP) rolls, making the states even more reliant on federal funds than they are today.[24] A federal bailout of state pensions could make states so dependent on the federal government that they would effectively become federal subsidiaries as opposed to independent entities.

Calls for Bailouts Already Developing

Most Americans probably believe a federal bailout of state pensions would not only be outrageous, but that it would never happen. But the same might have been said about Detroit and Wall Street in 2007. Indeed, politicians in some of the most troubled states and localities have already sought federal bailouts. Michigan's Detroit-area Congressman Hansen Clarke has introduced a bill, "The Detroit Growth and Stability Act of 2012" (H.R. 4308), which seeks half a billion dollars in federal loans to cover the city's immediate financial crisis, including its bloated and underfunded pension program. And Illinois Governor Pat Quinn, in his FY 2012 state budget, suggested seeking a federal guarantee of state pension debt as a possible solution to improve the solvency of the state's pension funds.[25]

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Other bailout options are being explored as well. Amidst multiple large-scale municipal bankruptcies in California,[26] the Golden State now has an initiative, Proposition 31, on the ballot this November which could shift any potential state-level burdens from future municipal bankruptcies onto taxpayers in other localities. Widely publicized as a much needed budget process reform initiative, the devil is in the details. Prop. 31 would set up an "optional" revenue sharing plan for local governments, but with localities given the choice between sharing a portion of their state funds or forfeiting them entirely, the revenue sharing plan may as well be considered mandatory. Under such a system, regional boards made up of unelected officials would determine how to use the shared revenues – be that for large-scale investment projects, to redistribute educational funds, or to bail out troubled local governments and pension systems. By essentially taxing fiscally prudent jurisdictions and redistributing their money to fiscally imprudent ones, it appears California is preparing to pass the buck before even more of its municipalities go bankrupt.

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Winners and Losers of a Federal Bailout of State Pensions

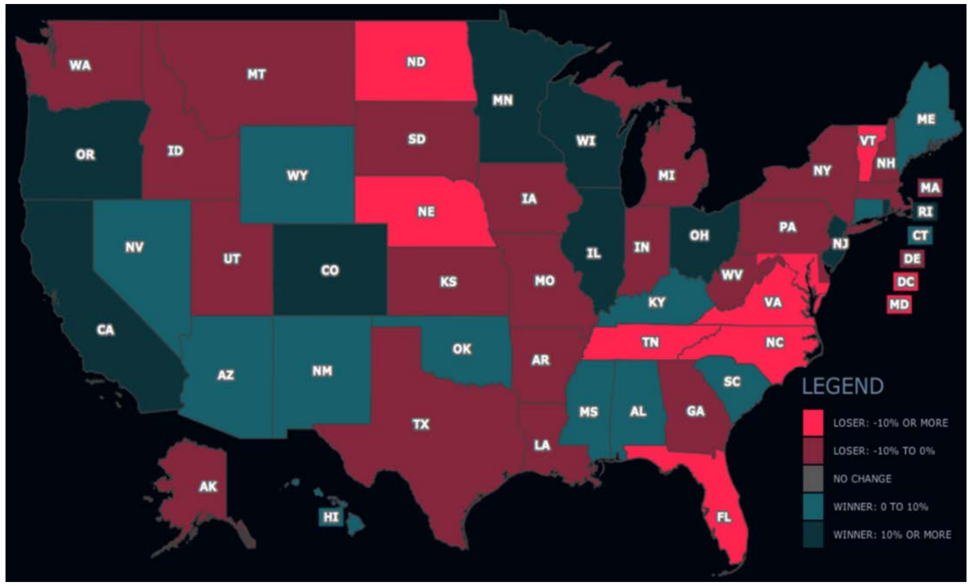
A recent analysis by the Illinois Policy Institute (IPI) shows which states (and localities) would be the winners and losers of a federal bailout of state pension funds.[27] The IPI analysis allows users to input different bailout scenarios including the percent of unfunded pension liabilities that are bailed out; the allocation of tax increases versus spending cuts to finance the bailouts; and the types of taxes raised and spending cut. Under any bailout scenario, there are winners and losers. The winners are states that would experience an increase in the amount of federal spending they receive per dollar of federal taxes paid (indicated in shades of blue in the graphs on the following page) while the losers (indicated in shades of red) would end up with less federal spending per dollar of federal taxes paid.

Under any bailout scenario, there are winners and losers.

If states and localities receive a bailout equal to 50% of their unfunded pension liabilities, and that bailout is financed entirely through income tax increases, the five biggest winners would be: Ohio, Illinois, Rhode Island, New Jersey, and Oregon, and the five biggest losers would be: Virginia, Tennessee, North Dakota, Maryland, and Nebraska (see graph on following page).[28] Nebraska, for example, would pay $2.10 more in taxes for each $1.00 it received in additional spending while Ohio would pay only $0.44 more in taxes for each $1.00 of additional spending it received.

The biggest winners of a bailout financed by income tax increases would be: Ohio, Illinois, Rhode Island, New Jersey, and Oregon. The biggest losers would be: Virginia, Tennessee, North Dakota, Maryland, and Nebraska.

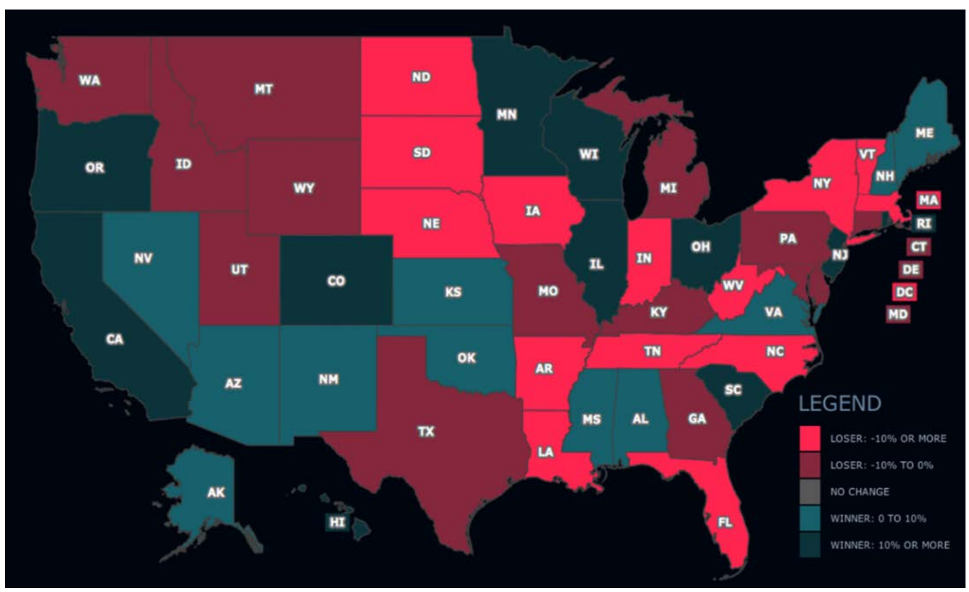
Winners and Losers: State Pension Bailout Financed by Tax Increases[29]



If the bailout were instead financed entirely through spending cuts (50% in grants to states and local governments and 50% in other direct federal spending), the five biggest winners would be: Ohio, Illinois, Colorado, Hawaii, and New Jersey, while the five biggest losers would be: Tennessee, North Dakota, Vermont, South Dakota, and West Virginia.

The biggest winners of a bailout financed by spending cuts would be: Ohio, Illinois, Colorado, Hawaii, and New Jersey. The biggest losers would be: Tennessee, North Dakota, Vermont, South Dakota, and West Virginia.

Winners and Losers: State Pension Bailout Financed by Spending Cuts[30]



Tennessee, North Dakota, and Vermont would all experience a greater-than 20% reduction in net federal spending while Ohio, Illinois, and New Jersey would all receive a more-than 30% increase in net federal spending.

Federal Pre-emption of a State Pension Bailout

The fiscal calamity facing many state pensions may be an obscure issue to the average American, but the problem could not be more apparent or predictable. It is simple math. States have promised a certain level of benefits to their employees, but they have not set aside enough money to pay those benefits. Little short of double-digit investment returns in coming decades can change the inevitable downfall of state pension funds (the Dow Jones Industrial Average has produced an average 3.5% return over the past decade and a long-run historical average of 7.7% since 1921).[31]

That is, unless states take action today to reform their pensions. But with public sector employee unions blocking any reforms and the federal government having set the bailout precedent, there is little incentive for state politicians to do the right thing, or voters to insist they do so. That's how moral hazard works – when bad behavior goes unpunished, you get more of it. As long as the federal government backed subprime mortgages, banks kept making them. As long as the European Union guaranteed Greece's bonds, the Greek government sank deeper into debt. In the same way, if homeowners believed that the federal government might soon write-down or entirely forgive mortgages, how many would keep making their payments each month?

Until a federal bailout is taken off the table, states that enact prudent policies and take the often painful actions required to live within their means will risk being penalized, while states that are unrestrained and irresponsible in their spending and promises will hold out for a federal recompense. Washington policymakers must act now to make it abundantly clear to states that they will not benefit from a federal bailout of state pensions.

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But simply passing legislation today stating there will be no federal bailout of state pensions is not enough – we have seen how many times Washington policymakers have waived or found a way around such rules in the past. Instead, policymakers must begin today by laying out the principles of what constitutes a sound pension plan and setting forth the penalties that would be applied to states seeking a federal bailout.

To preemptively deter states from seeking bailouts, the federal government could conditionally reduce federal aid to states in proportion to their unfunded liabilities until their pension fund becomes solvent over a specified future time frame. Alternatively, the federal government could revoke states' tax free bond status if conventional, private-sector accounting standards show that their pension funds are expected to go broke within 10 years or less.

As undesirable as a federal bailout of state pensions is, setting forth the terms and conditions of a potential bailout may be exactly what is needed to prevent one from happening. If the states understand how severe the terms of a federal bailout would be, they are more likely to take action now to fix their unsustainable pensions.

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[1] Joshua Rauh, "The Day of Reckoning for State Pension Plans," March 22, 2010, http://kelloggfinance.wordpress.com/2010/03/22/the-day-of-reckoning-for-state-pension-plans/.

[2] According to 2011 data from the U.S Census Bureau, the average per capita amount of federal grants to states among the five states with the lowest level (Virginia, Nevada, Florida, Colorado, and Georgia) was $1,397 while the average among the five states with the highest level (Alaska, Wyoming, New Mexico, New York, and Vermont) was $4,055. These estimates exclude the District of Columbia, which in 2011 is estimated to have the highest level of per capita federal aid, equal to $18,163.

[3] According to 2011 IRS tax data by state and Census population figures, the average federal tax burden per capita among the five lowest states (Mississippi, West Virginia, South Carolina, New Mexico, and Idaho) was $3,624, while the average per capita burden among the five highest states (Delaware, Minnesota, Connecticut, New Jersey, and Massachusetts) was $14,800. These estimates exclude the District of Columbia, which in 2011 is estimated to have the highest level of per capita federal taxes, equal to $31,746.

[4] State Budget Crisis Task Force, "Report of the State Budget Crisis Task Force," July 2012, http://www.statebudgetcrisis.org/wpcms/wp-content/images/Report-of-the-State-Budget-Crisis-Task-Force-Full.pdf.

[5] Ibid.

[6] Although the Governmental Accounting Standards Board (GASB) sets a measurement known as the Annual Required Contribution (ARC) for public pensions, states do not have to abide by the GASB standards, and even if they choose to do so, they can reduce their pension contributions simply by increasing their future rate of return assumptions.

[7] Robert Novy-Marx and Joshua Rauh, "Public Pension Promises: How Big Are They and What Are They Worth?" Journal of Finance, 66(4): 1211-49 (2011), forthcoming copy available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1352608.

[8] In 2009, Illinois' stated pension liabilities equaled $151 billion, while its assets equaled $65.7 billion (43.5% funded ratio). Using the taxable municipal bond rate, its liabilities equaled $160.7 billion, for a 40.9% funded ratio, and using the treasury rate, its liabilities equaled $233 billion, for a 28.2% funded ratio.

[9] Joshua Rauh, "The Day of Reckoning for State Pension Plans," March 22, 2010, http://kelloggfinance.wordpress.com/2010/03/22/the-day-of-reckoning-for-state-pension-plans/.

[10] Ibid.

[11] Christopher Wills, "S&P Lowers Illinois Credit Rating Over Pensions," Associated Press, August 29, 2012, http://finance.yahoo.com/news/p-lowers-illinois-credit-rating-over-pensions-175723342--finance.html

[12] From January 2012 through August 2012, Illinois' 10 year bonds sold at an average premium of 157 basis points compared to other AAA-rated states.

[13] Graphic from the Illinois Policy Institute, using data from: Robert Novy-Marx and Joshua Rauh, "Public Pension Promises: How Big Are They and What Are They Worth?" Journal of Finance, 66(4): 1211-49 (2011).

[14] James Sherk and Todd Zywicki, "Auto Bailout or UAW Bailout? Taxpayer Losses Came from Subsidizing Union Compensation," The Heritage Foundation, June 13, 2012, http://www.heritage.org/research/reports/2012/06/auto-bailout-or-uaw-bailout-taxpayer-losses-came-from-subsidizing-union-compensation

[15] The Congressional Budget Office estimates that the auto bailout will cost taxpayers a total of about $20 billion while the Treasury Department estimates it will cost about $23 billion. See: Congressional Budget Office, "Report on the Troubled Asset Relief Program–December 2011," December 16, 2011, Table 3, http://www.cbo.gov/sites/default/files/cbofiles/attachments/12-16-TARP_report.pdf See also: U.S. Department of the Treasury, "Troubled Asset Relief Program (TARP): Monthly Report to Congress–April 2012," Figure 2.

[16] Chrysler's unsecured creditors (who were owed $5 billion), as well as its second-lien secured creditors (who were owed $2 billion) were completely wiped out. GM's unsecured creditors received $8.1 billion in present value for the $29.9 billion they were owed, or 27 cents on the dollar.

[17] Jonathan Ingram, "CTU Demand Huge Raise on Top of Million-Dollar Pensions," Illinois Policy Institute, September 11, 2012, http://www.illinoispolicy.org/blog/blog.asp?ArticleSource=5041

[18] Calculations assume $15,000 per year contributions for 30 years and a nominal rate of return of 7.7%, which is equal to the historical average annual rate of return of the Dow Jones Industrial Average (1922 to 2011).

[19] Lawrence J. McQuillan, "Chicago Public School Teachers are Overpaid," Illinois Policy Institute, September 11, 2012, http://www.illinoispolicy.org/blog/blog.asp?ArticleSource=5040
[20] George F. Will, "Illinois is Running out of Time and Money," The Washington Post, April 25, 2012, http://www.washingtonpost.com/opinions/illinois-is-running-out-of-time-and-money/2012/04/25/gIQA7r4khT_story.html
[21] Office of Management and Budget, "Table 12.2: Total Outlays for Grants to State and Local Governments: 1940-2017," http://www.whitehouse.gov/omb/budget/Historicals
[22] Ibid.
[23] Congressional Budget Office, Long Term Budget Outlook 2010, June 30, 2010, http://www.cbo.gov/publication/21546
[24] Congressional Budget Office, "H.R. 4872, Reconciliation Act of 2010 (Final Health Care Legislation)," March 20, 2010, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/113xx/doc11379/amendreconprop.pdf
[25] Subsequent to Governor Quinn's budget proposal, a spokesperson from the Governor's office issued a statement saying, "the state of Illinois has not and does not intend to request any federal guarantee of any of its bonds."
[26] In June 2012, Stockton, California became the biggest U.S. city ever to file for bankruptcy. In July 2012, Mammoth Lakes, California went to federal bankruptcy court, and in August 2012, San Bernadino, California filed for bankruptcy status.
[27] Illinois Policy Institute, www.nopensionbailout.com
[28] The bailout scenario financed exclusively by income tax increases would be distributed 82% to individual income taxes and 18% to corporate income taxes, representing the 2010 breakdown of U.S. income taxes.
[29] Illinois Policy Institute, http://www.nopensionbailout.com/solutions/
[30] Ibid.
[31] Dow Jones Industrial Average.