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ECONOMIC PERSPECTIVES

UNDERFUNDED PENSIONS: THE EXPANDING AND ESCALATING CHALLENGE

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Puerto Rico's recent financial failures have raised public awareness of underfunded pensions, as well as questions about the federal government's proper role in pension failures. Regrettably, the problem is not unique to state governments—with low interest rates, unrealistic benefit promises, and poor funding, pension plans are under intense financial pressure at all levels of government and throughout the private sector.

Congress is already confronting escalating private pension problems, specifically for pensions insured by the Pension Benefit Guaranty Corporation (PBGC), an independent federal agency that covers single-employer and multiemployer private pension plans. While PBGC is federally sponsored, it is not backed by the full faith and credit of the federal government in case of insolvency (i.e., there is no federal obligation to bail out the program). PBGC's insolvency has become increasingly likely as the prospective failure rate for multiemployer pensions has risen dramatically over the past three years, driving record deficits for the entire program and threatening the finances of millions of workers and retirees.

Meanwhile, most states and localities have significantly underfunded their pension obligations, and the potential for shortfalls portends state fiscal crises that may elicit demands for federal intervention.

Political sympathy for retirees runs deep on both sides of the aisle, but federal financial intervention in a major pension failure would have a disastrous impact on the federal government's credit and debt. It would also create a dangerous disincentive for the responsible and prudent administration of pensions at all levels.

Below is a brief overview of recent developments related to failing pensions, the mounting shortfalls faced by the federal government's PBGC program, and the challenges faced by state pension plans.

RECENT DEVELOPMENTS

While early pension challenges have been relatively small, the way in which they are handled sets an important precedent for the exponentially larger pension challenges that lie ahead. Specifically, it is likely that a combination of benefit cuts, premium increases, and better future funding will be necessary to shore up failing pensions. While painful for current beneficiaries of failing pensions, this precedent could help remove expectations for federal bailouts, reinforce the understanding that individual pension plan sponsors are responsible for their own financial solvency, and prompt pension administrators to make the difficult—but critical—decisions necessary to address shortfalls. Further, such a precedent could help PBGC and state and local governments to avoid a large and painful insolvency.

- *The Detroit bankruptcy deal.* The City of Detroit filed for bankruptcy in 2013 after a series of state-ordered financial reports found that the city was insolvent. The resulting bankruptcy deal set a precedent by allowing a pension sponsor, the City of Detroit, to cut benefits in order to maintain the solvency of the pension plans. Retirees' pension payments were reduced by 4.5–20 percent.[1]

- *The Kline-Miller Multiemployer Pension Reform Act of 2014.* The Kline-Miller Act, named for its bipartisan cosponsors, Representatives John Kline (R-MN) and George Miller (D-CA), empowered private multiemployer pension plans to cut benefits to a minimum of 110 percent of what PBGC insures if doing so would avert insolvency (e.g., for 30 years of service, PBGC's maximum guarantee is $12,870 per year and may be less). The law, prompted by the increasing number of large multiemployer plans facing insolvency, envisioned that multiemployer pension funds would remain self-sufficient rather than relying on government assistance.

- *Puerto Rico.* The Puerto Rican debt crisis is the result of decades of government profligacy and inadequate pension funding and was ignited by a downgrade of the US territory's debt to junk status in early 2014.[2] Puerto Rico's pension system was 96 percent unfunded with a $44

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billion shortfall in 2014, according to the US Treasury. In dealing with the tension between government retirees and bond holders, US Treasury Secretary Jack Lew has stated, "We've never said that pensions should be made senior to all debt." Lew prescribed, and Congress legislated, a fiscal oversight board for Puerto Rico with "the discretion to make the trade-off decisions," including cuts to pension benefits.[3]

PBGC

As recently noted by Senior Research Fellow Charles Blahous of the Mercatus Center at George Mason University, as well as a host of other scholars and policy experts, PBGC faces historic financial challenges:

- PBGC insures private pensions and is funded by premiums assessed on pension sponsors. These premiums, set by Congress, are consistently too low to adequately fund the program. This problem is especially evident for the multiemployer fund, for which premiums would have to quadruple to reduce the chance of insolvency to less than 50 percent over the next 20 years.[4]

- For the single-employer fund, premiums and assets are likely sufficient to avoid systemic failure, although the continued legislative weakening of funding rules in response to low interest rates may put the fund in jeopardy.

- PBGC currently has a deficit—largely driven by the multiemployer fund—of $76.3 billion,[5] a figure that includes past pension failures and pensions expected to fail within the next 10 years. The program recently reported a 93 percent likelihood of failure in the multiemployer fund within 20 years,[6] threatening the retirement security of more than 10 million workers.[7]

- Central States Pension Fund, a multiemployer pension, is expected to fail within the next 10 years. Its failure would add 400,000 workers[8] to the nearly 1 million other retirees slated to receive PBGC benefits—a significant increase for an already struggling program.[9]

- Because the insured levels for multiemployer plans are substantially less than what solvent pension funds would pay out, even a sufficient insurance fund would not necessarily eliminate the demand for federal intervention in large, failing multiemployer plans such as Central States.

- Political sympathy for retirees runs deep on both sides of the aisle and may prompt discussion of a federal financial intervention if a plan were to fail. But such an intervention would set a disastrous precedent for all involved.

- Congress must act soon to strengthen PBGC's shaky finances—first, by giving PBGC more authority to increase premiums.[10] If the situation is allowed to worsen and PBGC's insolvency becomes inevitable, PBGC should follow the example set by the Detroit bankruptcy of 2013 by having pension sponsors and beneficiaries share the burden.[11]

THE STATES

According to states' own reporting, their total unfunded pension liabilities total nearly $1 trillion.[12] But this reported number does not tell the full story of the fiscal threat:

- Flawed government accounting methods have made it possible for policymakers to consistently underfund pensions. Because public-employee pensions are intended to be guaranteed regardless of market performance, pension fund liabilities should be valued using the risk-free discount rate, the rate of interest that the federal government pays on 15-year Treasury bonds.

- Applying a risk-free discount rate of 3.2 percent based on the yield on notional 15-year Treasury bonds on June 30, 2014, increases the total unfunded liability of state pension plans from $1 trillion to $4.3 trillion.[13] This total unfunded liability is four times larger than what states report. Applying the current risk-free rate of 1.74 percent would result in an even higher unfunded liability.[14]

- Instead of using the risk-free discount rate, state and local policymakers rely on the expected stock market rates of return to value their liabilities. But market returns are volatile, while benefits must be paid on a predictable schedule. This practice results in states having a slim chance of being able to fund retirees' benefits without raising taxes or cutting other state programs.[15]

- Despite the optimistic expected rates of return that municipalities use to value their liabilities, public-sector pension funds have seen declining returns since 2001.[16] In fiscal year 2016, the California Public Employees Retirement System saw returns of just 0.6 percent, less than half the rate of return that the S&P 500 saw during that time period.

- States and localities face powerful incentives to underfund their pensions because doing so allows them to spend more on projects that provide voters with immediate benefits. This practice creates the illusion that policymakers provide voters with benefits in excess of current tax revenues by pushing costs into the future.

While Puerto Rico's debts have made headlines, multiple American states and localities are facing fiscal distress driven in large part by unfunded pension liabilities:

- Since the 2008 financial crisis, six local governments have renegotiated their debts in bankruptcy court after being unable to meet their obligations: Hillview, KY; Detroit, MI; San Bernardino, CA; Stockton, CA; Jefferson County, AL; and Central Falls, RI.

- In most of these cases, unfunded pension liabilities played an important role in driving these jurisdictions to the point where they were unable to fund basic services such as emergency response, infrastructure maintenance, and education.

- Some major cities are reaching a similar position where their only options will be significant tax increases, spending cuts, or reneging on promised benefits. According to Government Accounting Standards Board rules, Chicago's unfunded liability stands at $18.6 billion. The Windy City now has the lowest credit rating of any major city except for Detroit.[17] Not all states allow their municipalities to use Chapter 9 bankruptcy as a vehicle to develop a plan for repaying their creditors, and Illinois is one state that does not permit municipal bankruptcy.

- Sovereign state governments have fewer options for negotiating with their creditors than municipalities do. Some states constitutionally protect workers' retiree benefits according to the benefit formula that was in place when they were hired. For example, Illinois state courts have found that Illinois policymakers cannot make any changes to the benefits that state workers will accrue in the future.[18] In addition to Illinois, the states facing the biggest pension shortfalls include Kentucky, Connecticut, and Pennsylvania.[19] State pension systems' unfunded liabilities dwarf those of their local counterparts, and state policymakers face fewer options for handling shortfalls.

THE RISKS OF A FEDERAL BAILOUT

Should a state reach the point where it can no longer make pension payments, the federal government will face a strong incentive to provide assistance. State policymakers who recognize their inability to keep pension promises have suggested that the federal government should step in to help them meet these obligations.[20] While a bailout may provide immediate relief for state budgets, it would create long-term risks for fiscal sustainability at all levels of government.

- Legal scholar Michael Greve points out that states can continue shortchanging programs like infrastructure maintenance and education to maintain pension benefits for some time, but eventually "the debts will come due. There are good reasons to fear that they cannot and therefore will not be paid in full. And there are reasons to fear that in that event, we will bail out the states in one form or another."[21]

- Congress might not support a bailout to the most distressed states at the expense of other states' taxpayers. Therefore, a possible scenario could be a "backdoor bailout" that benefits all states through existing intergovernmental transfer programs such as Medicaid, transportation, or education funding. The American Recovery and Reinvestment Act (ARRA), more commonly known as the stimulus bill of 2009, provided states with $140 billion to help balance their budgets, thus demonstrating a preview of potential future bailouts. ARRA helped states meet their immediate balanced-budget requirements, but it allowed them to avoid spending reforms that could have improved their long-run fiscal health.[22]

A bailout would create what economists call moral hazard by letting states know that if they accrue more debt than they can pay back, the federal government will simply increase transfer payments to allow them to continue meeting their obligations. Bond markets provide a check on the amount of debt that states can accrue, but if bondholders expect the federal government to prevent defaults, they may continue to buy municipal bonds that states cannot pay back.[23]A larger or more prolonged backdoor bailout would further reduce state policymakers' incentives for fiscal discipline. The American system of competitive federalism relies on state governments providing services to their residents out of the tax revenue that they raise locally. Backdoor bailouts for state pensions would further erode the incentive for states to manage their finances well because the federal government would be further subsidizing all state services. The federal government already faces an enormous fiscal gap, and increasing transfers to state governments would only exacerbate serious fiscal consequences at every level of government.[24]

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