NEED TO KNOW

AMERICANS FOR PROSPERITY FOUNDATION

UNFUNDED PUBLIC PENSIONS

For decades, federal, state, and local governments across the country have offered their employees generous retirement benefits without setting aside sufficient funds to make good on their promises. As a result, American governments now owe trillions of dollars in "unfunded liabilities" – the difference between the value of their assets and the obligations they owe their retirees. This gap has grown so large that most states now owe more in unfunded liabilities than in debt. Clearly American governments must get their unfunded liabilities under control or face fiscal crisis in the near future.

QUICK FACTS

- The average retires Illinois public school teacher receives an annual pension of $72,693 plus annual cost-of-living adjustments, which can make it as high as $97,693.
- In 2014, the New York Times found the worst sixteen states have a combined $786 billion unfunded pension liability.

THE PROBLEM WITH PENSIONS

By far the largest unfunded liabilities American governments face today are pensions. A 'defined benefit" pension is a promise made by an employer to provide a guaranteed and regular stream of income to an employee upon retirement. Most companies in the private sector have moved away from "defined benefit" pensions to a "defined contribution" system, such as 401(k)s, which let workers make their own investment decisions and avoid making inflated promises that must be dealt with in the future.

Government workers, on the other hand, still mostly have defined benefit pensions with expensive benefits that are out-of-line with the private sector. The benefit promises are often far greater than what taxpayers can afford to pay, thereby creating an unfunded liability. To give one example, the average retired Illinois public school teacher receives an annual pension of $72,693 plus annual cost-of-living adjustments, which can make it as high as $97,693 (1). In 2014, the New York Times found the worst sixteen states have a combined $786 billion unfunded pension liability (2).

BAD MATH HAS ONLY MADE THINGS WORSE

Unfortunately, this $786 billion figure is likely a conservative estimate. Economics are now examining for actuarial assumptions governments make when calculating their liabilities and discovering that they're almost always overly optimistic. Most public pension systems assume a 7-8% rate of return on the investments they make for the fund such as stocks, bonds, and property. However, pension systems don't always see such a high return with markets in constant fluctuation. Yet, governments are legally obligated to pay their pension recipients regardless of whether they have sufficient assets to cover the cost. As a result, the underfunded pension problem is exacerbated by poor actuarial assumptions.

To combat this misinformation, Andrew Biggs of the American Enterprise Institute conducted a fair market valuation of state governments' pension liabilities using a more realistic rate of return. According to Biggs' calculations, states owe over $3 trillion in unfunded liabilities – a debt more than three times larger than what they are reporting (4).

DEFINED CONTRIBUTION REFORM

While adopting more realistic assumptions about pension systems' rate of return is a necessary first step down the road to reform, more fundamental changes will need to be made for states to evade fiscal crisis. Any public pension system will inevitably carry unfunded liabilities of its defined benefits, legally obliging the government to pay a fixed amount of money to each retiree regardless of its assets. Instead, public pension systems should adopt the defined contribution model favored by the private sector.

Under defined contribution, each employee chooses how much of their paycheck they wish to contribute to their retirement fund and where to invest the savings. The employer then matches the employee's contributions up to a certain rate, usually 3-4%. In this manner, the employer assumes no unfunded liabilities whatsoever and the employees enjoy greater control of their retirement savings.

The State of Michigan enacted such a reform in 1997, enrolling all government employees after March 31st of that year in a defined contribution plan instead of its debt-ridden defined benefit pension. As a result, the Great Lake State is estimated to have saved between $2.3 billion and $4.3 billion in unfunded liabilities from 1997 to 2010. Other states can also save their citizens billions of dollars by adopting similar defined contribution reforms because, at the end of the day, it is the taxpayer who is ultimately responsible for public pension systems' fiscal woes if they cannot stay afloat.

CONCLUSION

As if governments' fiscal problems aren't bad enough in this age of high debt and low economic growth, unfunded pension liabilities threaten to destabilize American government as we know it. For the sake of millions of taxpayers and thousands of civil servant retirees, pension systems must make more actuarially sound assumptions and switch to defined contribution or risk collapse.

Endnotes:
1. Online at: http://www.illinoispolicy.org/policy_posts/average-government-pensions-in-illinois/
2. Online at:
http://www.nytimes.com/2014/02/25/us/efforts-to-rein-in-public-sector-pension-costs-are-falling-short-experts-say.html?_r=0

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