Pension Security Bonds: A New Plan to Address the State Pension Crisis

Joshua Rauh
Associate Professor of Finance
Kellogg School of Management at Northwestern University

Robert Novy-Marx
Assistant Professor of Finance
University of Chicago Booth School of Business

The federal government should be worried about state pension liabilities. In the absence of fundamental reform, some large state pension funds may not last through this decade. When the funds run through their assets, the size of promised benefit payments will be so large that raising state taxes enough to make these pension payments will be infeasible. Just as the European Union is not standing back to watch Greece fail, the federal government will face massive and likely irresistible pressure to bail out the affected state governments.

Take Illinois for example. If its main three pension funds earn 8% returns and the state makes enough contributions to secure new benefits that it promises in the coming years, those funds will run out of money in 2018. At that time, benefit payments owed to the workers who are already in today’s state workforce will be an estimated $14 billion per year. That is half of the $28 billion in revenues that Illinois is expected to have received in 2010.

While this problem is particularly severe in states such as Illinois, Connecticut, and New Jersey, many more states have public pension systems that appear unsustainable even on a 15-year horizon (see Rauh (2010)). The situation will be exacerbated if mobile taxpayers, frustrated with half of their tax remittances going to pay pensioners, flee to states that can provide lower taxes and higher services. The total size of the potential bailouts would likely exceed the recent bailout of the U.S. financial system.

When a country gets into fiscal trouble, the policy prescription is usually that the country should implement fiscal austerity measures such as tax increases, spending cuts, and pension reforms. These measures essentially balance the budgets of future years, or at least bring them closer to balance. The improved budget then allows the country to borrow the inevitably large sums of money required to prevent the legacy liabilities from shutting down the government entirely. For example, supranational organizations like the European Union or International Monetary Fund have come in to loan money to Greece on the condition of major reforms.

In the case of the US states, the legacy liabilities are the pension promises to state and local government workers, and the higher-level government that is on the hook is our own federal government. Under a number of state constitutions, promised pension benefits have a legal priority that is senior even to general obligation bonds. States cannot simply back out of these payments. Troubled states that are interested in preventing a crisis should therefore take a page out of the book about sovereign fiscal
crisis. They should combine drastic fiscal and pension reforms with increased borrowing to keep them operating despite the coming flood of benefit payments.

A key reform for states in pension trouble would be the closing of defined benefit pension plans to new workers, an arrangement called a “soft freeze.” Current employees would continue to earn traditional pension benefits under the existing programs, but retirement benefits for future work come under a new defined contribution plan. These changes must be enacted with an eye towards giving new public employees adequate retirement benefits. Those that are not in Social Security must be brought into Social Security, and the new defined contribution plan must be adequate for supporting the retirement of public employees. Like the Federal Thrift Savings plan, the new plan must have automatic enrollment, matching employer contributions, low fees, good investment choices, sensible default allocations, and reasonably priced offers for annuities at retirement.

Once a state or municipal government has stopped pension benefits from growing, it becomes more feasible for the state to issue debt to finance the existing liabilities. The goal is to get over the big hump in benefits owed coming in the next 10 to 15 years. If states can claim to have put their futures on a more economically sustainable path, they can use debt responsibly to get them past this difficult period.

If states were acting in our national interests, they would be considering these actions on their own. Any state that embarks on this program of action today will lock in low borrowing rates today compared to the municipal rates that would prevail in the event of an all-out crisis. Unfortunately, to the extent that state governments have taken action, it has been largely with cosmetic adjustments to existing systems.

It therefore falls to the federal government to give states incentives for pension reform, so that US taxpayers do not ultimately bear a massive burden to bail out profligate states. We therefore propose the following program. The federal government should cut a deal with the states. They should offer tax subsidies for the debt needed to fund legacy liabilities, but only to states state willing to close their defined benefit pension plans to new workers.

Under current law, bonds floated by states to fund pensions are taxable and enjoy no federal subsidies. As a result, issuing debt to fund pension plans is considerably more expensive than issuing regular tax-exempt municipal bonds, or the federally subsidized Build America Bonds, on which the federal government reimburses 35% of all coupon payments directly to the state.

The federal government’s deal with the states would work as follows. They should allow a state to issue tax subsidized bonds for the purpose of pension funding for the next 15 years — if and only if the state government agrees to take three specific measures to stop the growth of unfunded liabilities:

1.) The state must close its defined benefit plans to new employees under a “soft freeze” and agree not to start any new defined benefit plans for at least 30 years.

2.) The state must annually make exactly its actuarially required contribution (ARC) left over from the existing underfunded plans; only the amount of that ARC will be tax deductible.
3.) The state must include its new workers Social Security, and provide them with an adequate defined contribution plan, again for at least 30 years. To this end, the federal government should start a Thrift Savings Program for state workers and operate it alongside the existing Thrift Savings Program for federal workers.

The tax subsidies for these new Pension Security Bonds would work like Build America Bonds, with the federal government paying 35% of all coupon payments directly to the state.

How much will this plan cost? Employer actuarially required contributions for fiscal 2008 were approximately $67 billion, so the federal government is allowing potentially this much of new tax-exempt borrowing for each of the next 15 years. This brings $1.0 trillion in new debt to the municipal market.

Assuming states issue 30-year bonds, this tax subsidy would cost around $250 billion. However, a large fraction of these costs are offset by the fact that new state workers would be in Social Security. According to estimates by Peter Diamond and Peter Orszag, if all newly hired state and local government workers were on Social Security, it would eliminate 10% of the program's 75-year actuarial deficit, which today stands at $5.3 trillion. A little over two-thirds of state and local workers are on state-sponsored defined benefit pension plans, so bringing these workers into Social Security would save 7% of that deficit, or $370 billion. If guarantees by the state to bring new workers into Social Security are only valid for half of the 75 years, the savings from the Social Security expansion would still be over $175 billion. Including these gains to the Social Security system, the net cost to the federal government of the entire stabilization program would be only $75 billion.

What about the cash flow of the states themselves? Social Security costs 12.4% of pay and is divided equally among employer and employee. A typical defined contribution plan might cost 9% of pay, the division of which varies. Total costs would therefore be 21.4% of pay. In comparison, the Illinois teachers plan cost 26.4% of pay in 2009. The CalPERS plans cost anywhere between 21.6% of pay for the least expensive workers to 40.1% of pay for the highway patrol plan. Our proposal would allow states to borrow to meet their share of those costs for existing workers, while establishing more sustainable systems for new workers.

This plan offers substantial benefits to numerous parties. Specifically, pension promises made by states to their existing workers become more secure, since the funding of these obligations will greatly improve. New state workers will get a retirement plan that is more than an empty promise. Taxpayers will avoid massive future tax increases and loss of public services. And critically, state politicians will no longer be able to use pensions as a vehicle for borrowing off the books at horizons that extend beyond their political careers.

While defined contribution pension plans have some drawbacks, they are immune to the key accounting and accountability issues that have brought many states to the brink of insolvency. States and their employees have for decades been operating under a pretense that promised pension benefits somehow do not represent a real cost, since they will not have to be met for many years. Politicians have found it convenient to make promises that do not come due until long after their own terms are over. State
worker representatives have helped enable this behavior, and even encouraged it, by happily trading current compensation for future benefits on beneficial terms. We are now seeing the consequences of what happens when those promises come due.

Some might argue that the federal government should simply take a hard line with states and announce today that it will not, under any circumstance, bail them out of their pension problems, which would itself incentivize the states to consider fiscally responsible behavior. But this claim suffers from the classic problem of time inconsistency. The inability to make credible commitments against bailouts made it impossible for the US government to refuse to bail out large banks, and led to the recent bailout of Greece by the rest of Europe. The federal government would almost certainly come to the rescue rather than watching a state fail. It is therefore imperative that we act today by giving states incentives to put themselves back on a path to fiscal sustainability.

References