

Pension Liabilities

Background

In 2009, Alabama's state and local governments employed 324,669 full- and part-time workers, up 114 percent since 1969. Put another way, 20.86 people work in state and local government for every 100 that work in the private sector, the 11th highest ratio in the nation.

Alabama's state and local government workers also earn significantly more than the average private sector worker. Even though Alabama's state and local government workers' wages and salaries were 0.7 percent lower than the private sector in 2009, their benefits were 64.3 percent higher than workers in the private sector, the 12th highest ratio in the country.

This workforce is imposing an enormous burden on taxpayers. In 2009, the total cost of wages, salaries, and benefits (including pensions and insurance) to employ Alabama's public workforce was \$16.5 billion, or about 15.5 percent of all earnings in Alabama.

Both employment and compensation problems are significant contributing factors to Alabama's unfunded pension and retiree health care liability. According to official state estimates, Alabama's pension system in FY 2009 was underfunded by \$10.9 billion while the retiree health care system is underfunded by another \$15.3 billion.

As a result of these liabilities, the amount of money needed to pay for Alabama's pension and retiree health care system (called Other Post-Employment Benefits, or OPEB) is larger than it would be otherwise. In fact, the required (not actual) FY 2009 state pension and retiree health care contribution combined (\$2.5 billion) would

ISSUE SNAPSHOT

In 2009, state and local government wages and salaries were 0.7 percent lower than private sector.

Nationally, the wage and salary ratio in 2009 was -4 percent.

Over that same period, Alabama state and local worker benefits were 64.3 percent higher than workers in the private sector, the 12th highest ratio in the country.

have consumed almost all of the state's individual income tax (\$2.7 billion).

Because contributions to Alabama's OPEB are lower than needed, one estimate suggests that the state's pension system is underfunded by \$47.8 billion—nearly five times official estimates—and will run out of assets by 2023.ⁱ

Policy Consideration

Three options are available to Alabama policymakers to solve the state's pension and retiree health care crises: (1) raise taxes; (2) reduce other government spending; or (3) reform the state's pension and retiree health care systems. Since raising taxes would only weaken Alabama's economy and jeopardize the state's ability to meet its retiree obligations, the only viable options are to reduce other government non-pension spending, especially over-employment in the government workforce, and reform retiree pension and health care benefits.

GUIDE TO THE ISSUES

Recommendation

If the obligations the State of Alabama has to its government employees are to be met, the existing system must be reformed in the following ways:

- The ratio of public sector-to-private sector employees must be lowered. Bringing Alabama's ratio of state and local government employees in line with the national average of 17.67 per 100 private sector employees would shrink its workforce by 49,600 people and save up to \$2.4 billion per year.
- Due to the extent of the unfunded pension liabilities in the defined benefit pension systems across the country, more and more states have been moving towards a defined contribution system—similar to the 401(k) system that is popular in the private sector. Alabama should join this movement in order to reduce the long-term costs of the pension system. This could be done by (1) moving all new government employees into a defined contribution system; (2) moving employees into both defined benefit and defined contribution systems; or (3) having government employees choose between a defined-benefit plan and a defined-contribution plan.
- Because annual pension contributions come from the state, there is an unwritten assumption that taxpayers will ultimately be responsible for covering any funding shortfalls. In reality, a better way to fully fund Alabama's pension plans is through reforming the plans themselves.

According to a 2010 study by Robert Novy-Marx and Joshua Rauh on pension reform options, eliminating all cost-of-living adjustments (COLAs) nationwide would save approximately 22 percent of current pension liabilities, while another 22 percent could be saved if the each state's pension plan was adjusted to the same standards as Social Security (i.e., increasing the full retirement age to 67 years, increasing the early retirement age to 65 years and implementing early retirement age buyouts).ⁱⁱ

- When it comes to funding state pension obligations, reducing government contributions is a better choice than raising taxes. According to a 2009 report by Harvard economists Alberto Alesina and Silvia Ardagna, nations that cut spending are more likely to reduce deficits and avoid recessions than those that raised taxes.ⁱⁱⁱ Another state-specific study done in 2003 found that... "If anything, most public services do not appear to justify the taxes needed to finance them . . . this finding would seem to imply that other state and local public capital has been increased to the point of negative returns, perhaps because a growing stock of other public capital is indicative of an increasingly intrusive government."^{iv}
- Borrowing money to reduce the state's unfunded pension liability would be a large risk. The gamble is that the returns earned on investing the borrowed money would exceed the costs of borrowing the money. For example, when Illinois issued \$10 billion in Pension Obligation Bonds (POBs) in 2003, an 8.5 percent rate of return was assumed in order to make the plan work.^v Given the pounding that interest rates have received in the current recession, most POBs issued since 1992 are in the red.^{vi}

Further Reading

- J. Scott Moody and Wendy P. Warcholik, "The Looming Crisis in State and Local Government Employee Compensation and Pensions." Alabama Policy Institute, March 25, 2011. Available at <http://tinyurl.com/3bktbh7>. Access verified April 5, 2011.

ⁱ Robert Novy-Marx and Joshua Rauh, "Public Pension Promises: How Big Are They and What Are They Worth?" *Journal of Finance* (forthcoming), October 8, 2010. Available at <http://tinyurl.com/4w3kc5k>. Access verified January 10, 2011.

ⁱⁱ Robert Novy-Marx and Joshua Rauh, "Policy Options for State Pensions Systems and Their Impact on Plan Liabilities." Prepared for the NBER State and Local Pensions Conference in Jackson Hole, Wyoming, August 2010. Available at <http://tinyurl.com/6gyenpb>. Access verified January 12, 2011.

ⁱⁱⁱ Alberto Alesina and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes versus Spending," NBER *Working Paper* No. 15438, October 2009. Available at <http://tinyurl.com/6ysnueq>. Access verified January 12, 2011.

^{iv} Stephen P. A. Brown, Kathy J. Hayes, and Lori L. Taylor, "State and Local Policy, Factor Markets, and Regional Growth." *Review of Regional Studies*, Vol. 33, No. 1, 2003, pp. 40-60. Available at <http://tinyurl.com/4g5lnvs>. Access verified January 12, 2011.

^v J. Scott Moody, John Tillman, and Wendy P. Warcholik, "Mission Possible: An Update to the Pension Funding and Fairness Act," Illinois Policy Institute, *Policy Brief*, June 9, 2010. Available at <http://tinyurl.com/34ndugc>. Access verified March 15, 2011.

^{vi} Jean-Pierre Aubry, Thad Calabrese Ashby Monk, and Alicia H. Munnell, "Pension Obligation Bonds: Financial Crisis Exposes Risks." Center for Retirement Research at Boston College, *State and Local Pension Plans*, No. 9, January 2010. Available at <http://tinyurl.com/45w6dco>. Access verified January 12, 2011.