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Pension Policy & the Decline in Fiscal Democracy

University of Chicago Policy Forum
The Pension Crisis: State and Local Pension Challenges

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Introduction

Summary

A time of extraordinary possibility, not austerity

Yet constrained by a disease unique to our time:

A huge decline in fiscal democracy

- Culmination of decades of effort to control an uncertain future
- Deficits only one symptom

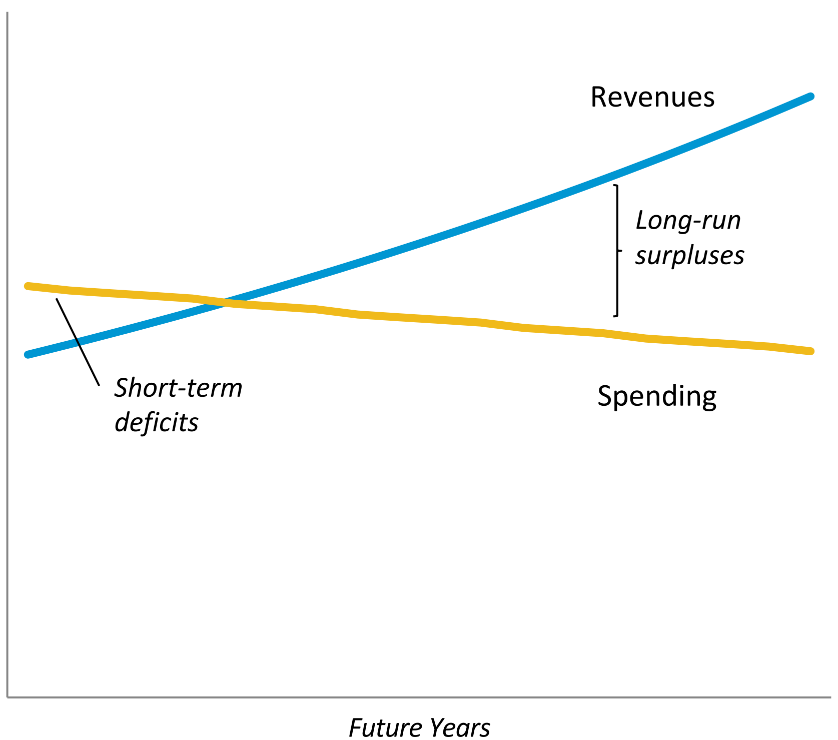
Real reform requires looking far beyond deficits to the purposes of policy

How today really is different

Traditional Budget

Revenues increase with economic growth.
Spending increases only with new legislation.

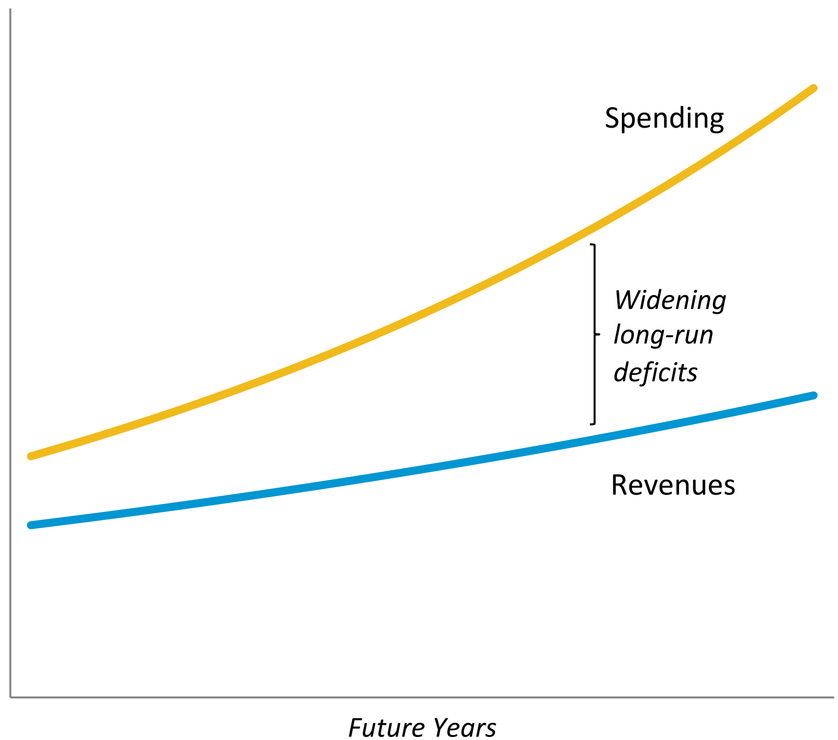
Real Dollars



Today's Budget

Spending scheduled to grow automatically faster than revenues.

Real Dollars



Many Deadly Consequences

Economic

Budget for a declining nation, abandoning children & investment

Look not just to what is growing automatically but what is getting squeezed

Lack of flexibility to meet new economic conditions & needs

Political

Decline in our democratic institutions

Real reform difficult when politicians must renege on promises

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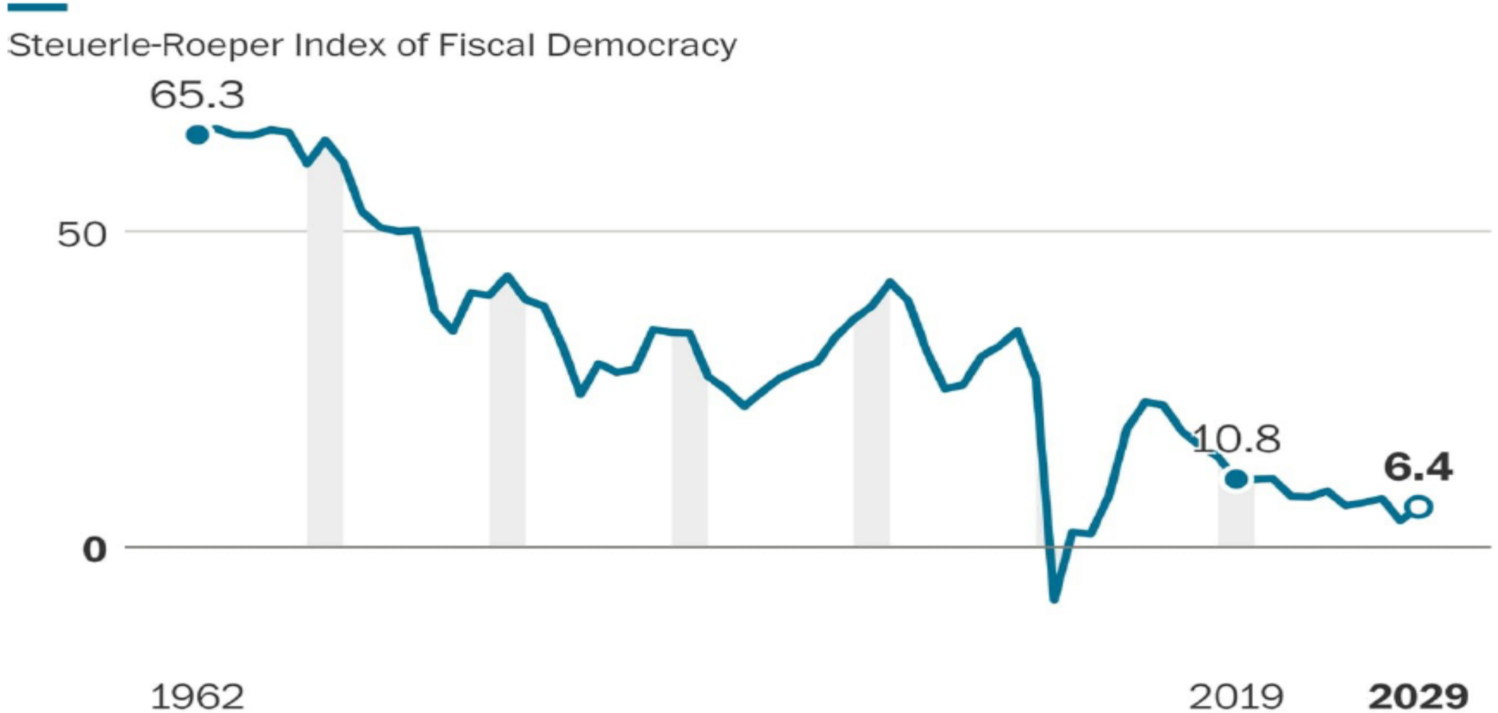
Measuring the Decline in Federal Fiscal Democracy

Decline in Fiscal Democracy at the Federal Level

‘Fiscal democracy’ is vanishing

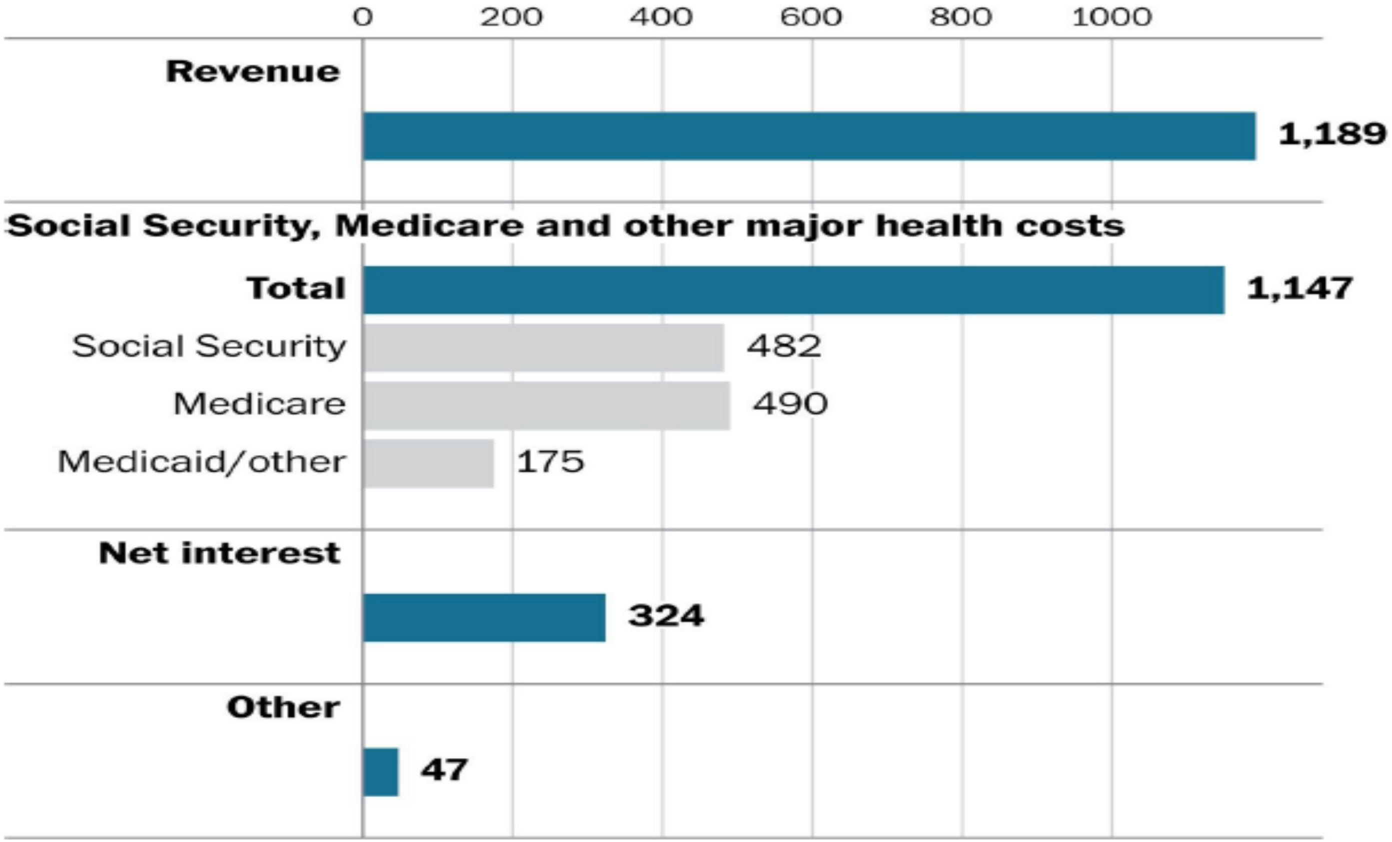
After paying interest on the debt and accounting for mandatory spending, the percentage of federal receipts left to spend each year has been shrinking rapidly.



Source: Calculations based on data from OMB and CBO

Health, Social Security and interest payments will dominate future budgets

Increase over 2018 budget by 2029 under current law, in billions of 2018 dollars



Notes: Other major health programs include CHIP and Affordable Care Act subsidies.

Source: Author's calculations from August 2019 Congressional Budget Office data.
THE WASHINGTON POST

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Measuring the Decline in Fiscal Democracy in Illinois

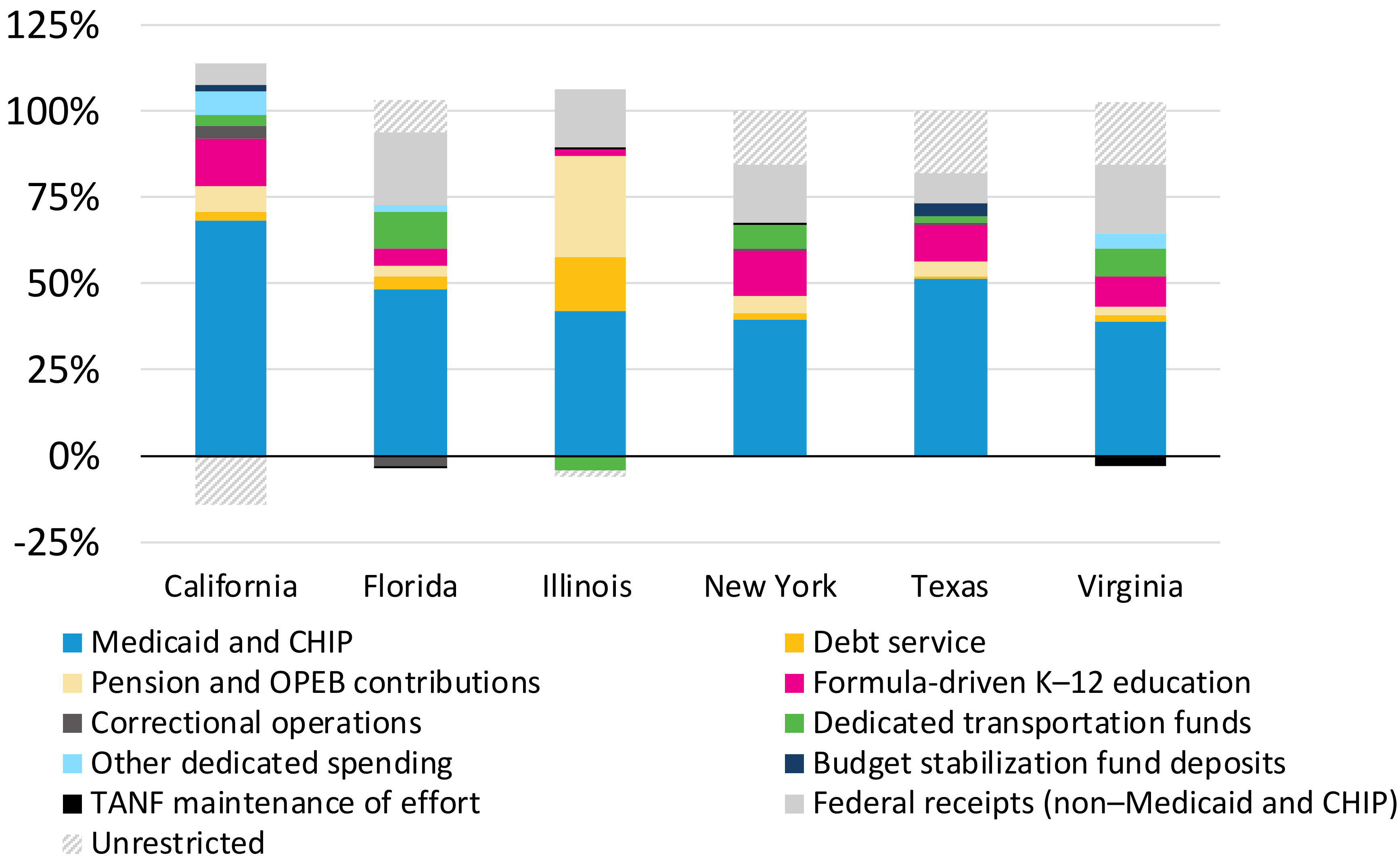
From Decrying to Measuring Declines in State Fiscal Democracy

- Governors & lawmakers have long decried their lack of flexibility
  - "… the way the formulas now work, we will never catch up. No matter how well we do, the current system is programmed to spend even more."

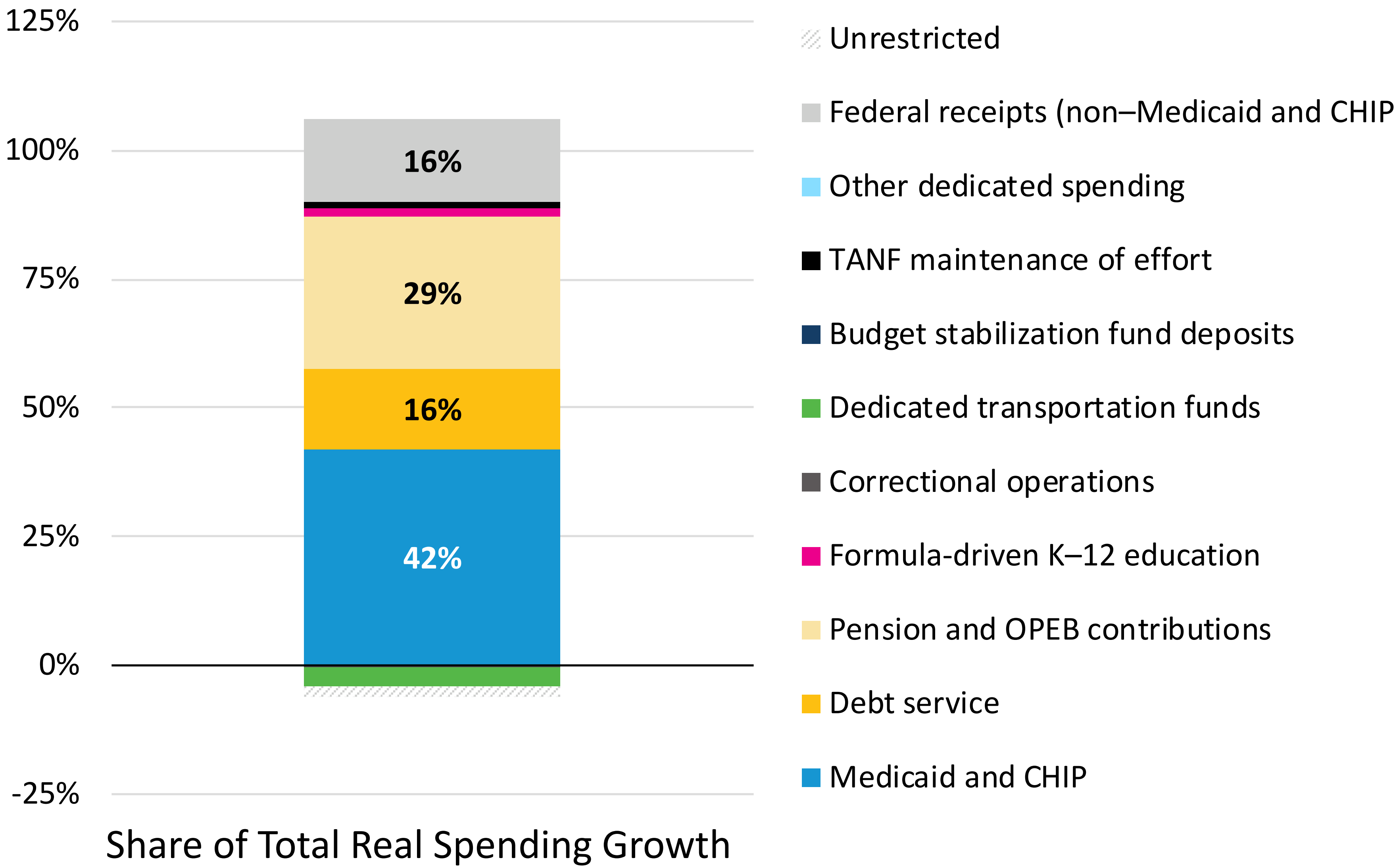
    2005, Governor Arnold Schwarzenegger
  - "…I don't think folks understand how limited you are in what you can cut. Everything that you can cut, we already have."

    Illinois State Senator Heather Steans
- But states rarely systematically evaluate
  - how much is out of current decision makers' control
  - how budget pre-commitments are changing over time

Restricted Spending, Share of **Real Spending Growth** (FY2015 vs. FY 2000)



Illinois Growth in Restricted Spending (FY2015 vs FY2000)



Illinois State Pension Policy

Pension Plans Should be Assessed by Multiple Criteria

Most reports focus on

Funding ratio

Making required contributions

But the purpose of pensions should be related to outcomes

Rewarding and attracting the best young, workers

Promoting a dynamic workforce

Encouraging work at older ages, especially given population aging

Retirement income for short-term employees

Retirement income for long-term employees

Equal pay for equal work

Grading Illinois State & Local Pension Plans

Illinois

Overall	Overall Grade	Rewarding Younger Workers	Promoting a Dynamic Workforce	Encouraging Work at Older Ages	Retirement Income for Short-Term Employees	Retirement Income for Long-Term Employees	Making Required Contributions	Funding Ratio
All	C	C	B	F	C	B	D	D
Only new hires	D	F	B	C	F	B	D	D
Excludes new hires	C	C	B	F	B	B	D	D

General State	Overall Grade	Rewarding Younger Workers	Promoting a Dynamic Workforce	Encouraging Work at Older Ages	Retirement Income for Short-Term Employees	Retirement Income for Long-Term Employees	Making Required Contributions	Funding Ratio
All	C	C	C	D	B	A	C	F
Only new hires	C	F	B	A	F	A	C	F
Excludes new hires	C	C	C	F	A	A	C	F
(IL01) Hired before Jan. 1, 2011 (Tier 1)	C	C	C	F	A	A	C	F
(IL02) Hired on or after Jan. 1, 2011 (Tier 2)	C	F	B	A	F	A	C	F

General Local	Overall Grade	Rewarding Younger Workers	Promoting a Dynamic Workforce	Encouraging Work at Older Ages	Retirement Income for Short-Term Employees	Retirement Income for Long-Term Employees	Making Required Contributions	Funding Ratio
All	C	C	B	F	B	A	F	C
Only new hires	D	F	B	D	F	A	F	C
Excludes new hires	C	B	B	F	A	A	F	C
(IL05) Hired before Jan. 1, 2011 (Tier 1)	C	B	B	F	A	A	F	C
(IL06) Hired on or after Jan. 1, 2011 (Tier 2)	D	F	B	D	F	A	F	C

Grading Illinois State & Local Pension Plans (cont.)

Teachers	Overall Grade	Rewarding Younger Workers	Promoting a Dynamic Workforce	Encouraging Work at Older Ages	Retirement Income for Short-Term Employees	Retirement Income for Long-Term Employees	Making Required Contributions	Funding Ratio
All	D	D	B	F	D	C	C	F
Only new hires	D	F	B	D	F	D	C	F
Excludes new hires	D	D	B	F	D	C	C	F
(IL09) Hired before Jan. 1, 2011 (Tier 1)	D	D	B	F	D	C	C	F
(IL10) Hired on or after Jan. 1, 2011 (Tier 2)	D	F	B	D	F	D	C	F

Police and Fire	Overall Grade	Rewarding Younger Workers	Promoting a Dynamic Workforce	Encouraging Work at Older Ages	Retirement Income for Short-Term Employees	Retirement Income for Long-Term Employees	Making Required Contributions	Funding Ratio
All	F	F	D	D	F	B	D	D
Only new hires	D	C	C	B	F	C	D	D
Excludes new hires	F	F	F	F	F	A	D	D
(IL03) State police and firefighters hired before Jan. 1, 2011 (SRS) (Tier 1)	F	F	D	F	F	B	C	F
(IL04) State police and firefighters hired on or after Jan. 1, 2011 (SRS) (Tier 2)	F	F	F	A	F	D	C	F
(IL07) Local sheriffs and deputies hired before Jan. 1, 2011 (IMRF) (Tier 1)	F	F	F	D	F	A	F	C
(IL08) Local sheriffs and deputies hired on or after Jan. 1, 2011 (IMRF) (Tier 2)	C	B	B	C	F	A	F	C

Underfunding of State Pension Plans

Pension Funding Status in Six States, 2016

Funding ratio estimates, share contributed, and net amortization

	US state total	CA	FL	IL	NY	TX	VA
Funded ratio (%)[a]							
Pew	66	69	79	36	91	73	72
BEA	48	51	58	25	60	51	52
Share contributed (%)[b]	88	82	101	75	152	71	101
Net amortization (millions $)[c]	-13.2	-2.9	0.0	-2.6	1.8	-1.6	0.0

Sources: Pew (2018); and US Census Bureau and BEA, "Financial Accounts of the United States," accessed via "State and Local Government Pension Funding Ratios, 2002 – 2016," Board of Governors of the Federal Reserve System, October 4, 2018, https://www.federalreserve.gov/releases/z1/dataviz/pension/funding_ratio/map/.

Notes: BEA = US Bureau of Economic Analysis; Pew = Pew Charitable Trusts.

[a] "Funded ratio" is actuarial assets divided by actuarial accrued liabilities; differences between Pew and BEA estimates are based on the discount rates used in calculations.

[b] "Share contributed" is actual employer payments (state or other) toward current benefits plus unfunded liabilities divided by the recommended payment for the current year (i.e., the actuarially determined contribution) (Pew 2018).

[c] "Net amortization" is all contributions (employer, employee, and other, with interest) minus the net service cost and interest on the prior year's debt. Plans with negative net amortization can expect to see their funding gap increase (Pew 2018).

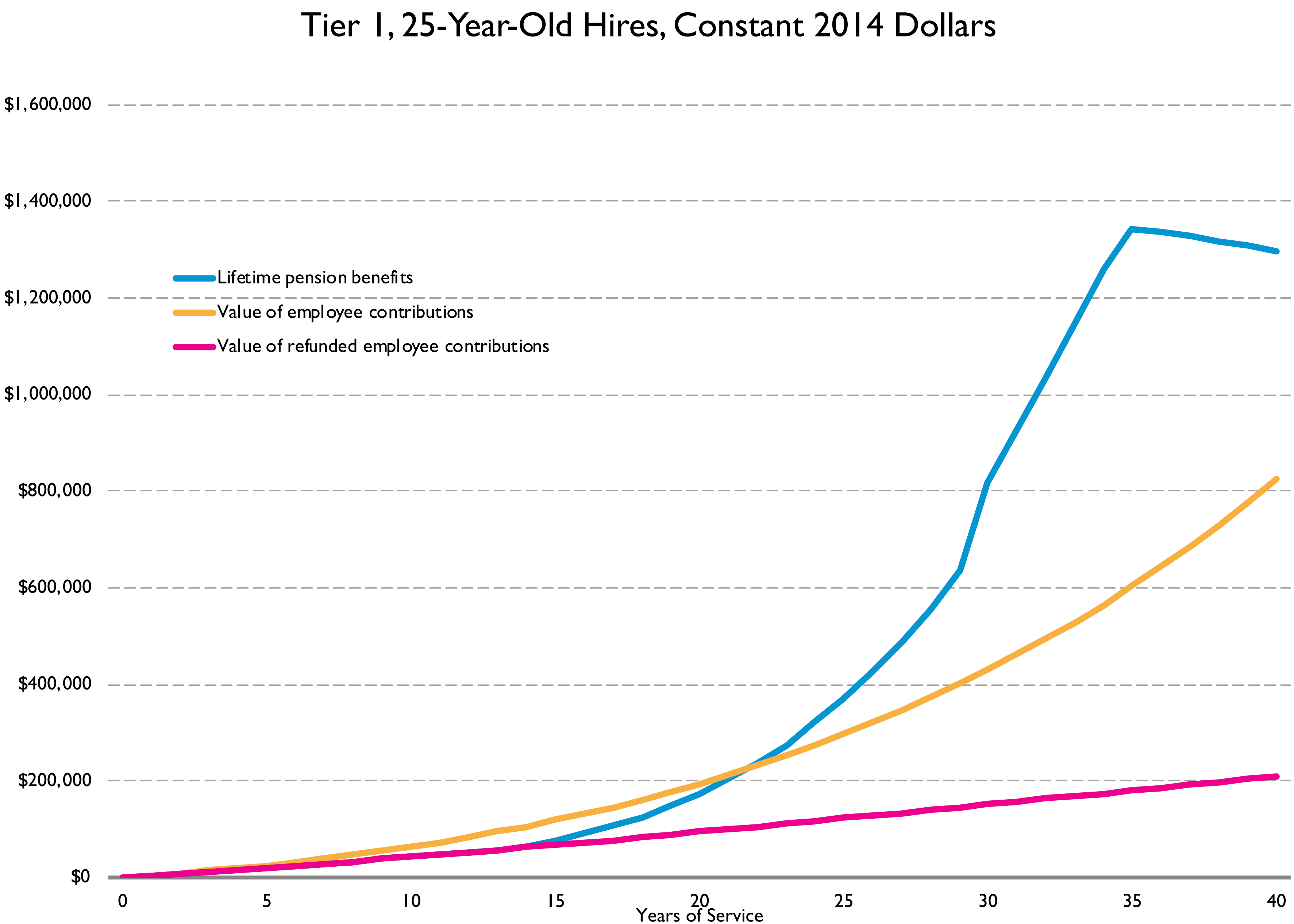
Do Budgeteers & Actuaries Bear Some Responsibility?

For basing funding estimates on optimistic assumptions?

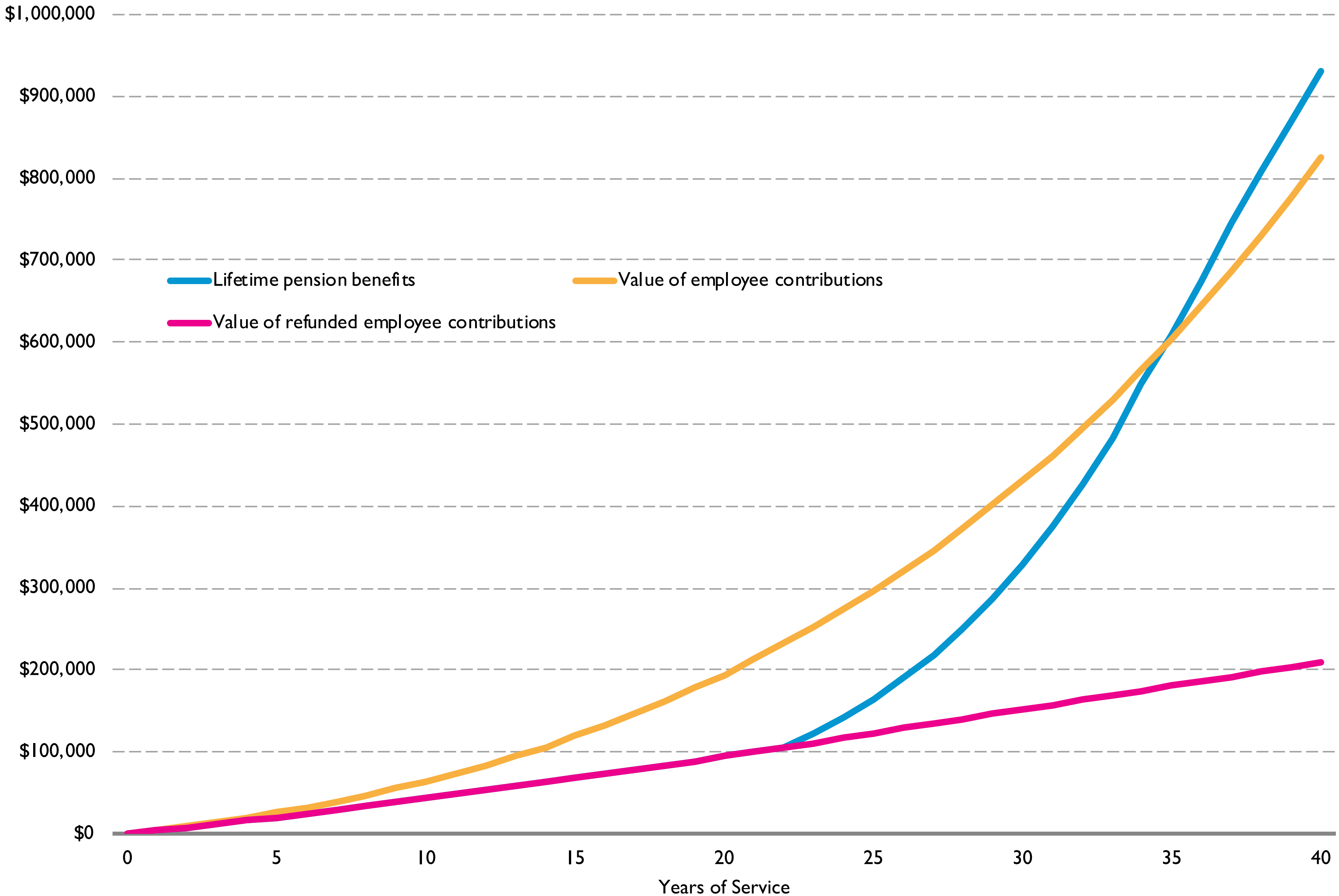
- Do not account adequately for the “cost” of downside risks
- Do not “insure” against downside risks
  - But doing so means earning Treasury rates of return
- Count on market crashes to improve rates of return

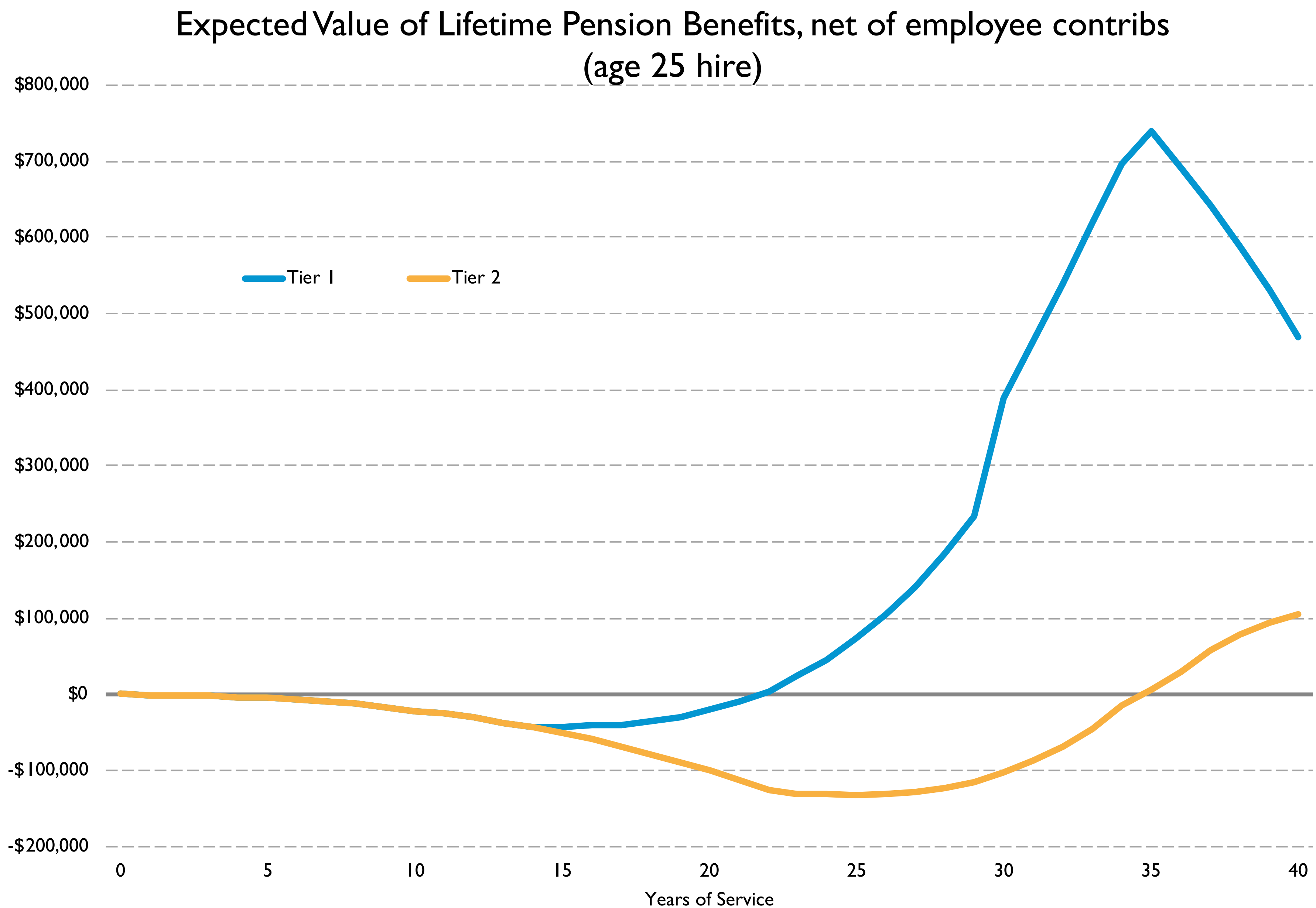
For failing to reveal effective pension compensation to workers?

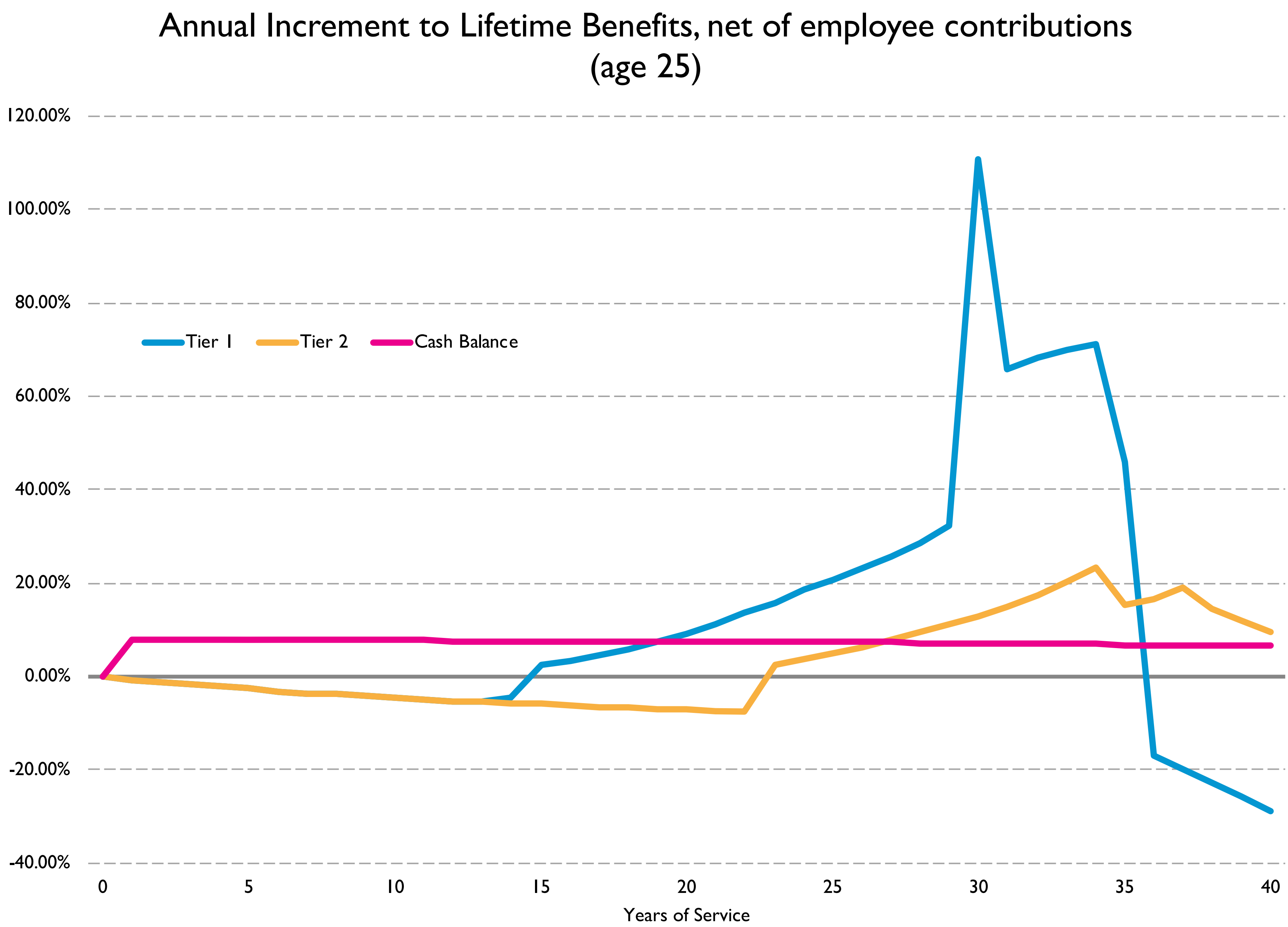
…Examples to follow for Illinois public school teachers


Tier 1, 25-Year-Old Hires, Constant 2014 Dollars
$1,600,000
$1,400,000
$1,200,000
$1,000,000
$800,000
$600,000
$400,000
$200,000
$0
Lifetime pension benefits
Value of employee contributions
Value of refunded employee contributions
0
5
10
15
20
25
30
35
40
Years of Service

Tier 2, 25-Year-Old Hires, Constant 2014 Dollars




Expected Value of Lifetime Pension Benefits, net of employee contribs
(age 25 hire)
$800,000
$700,000
$600,000
$500,000
$400,000
$300,000
$200,000
$100,000
$0
-$100,000
-$200,000
Tier 1
Tier 2
0
5
10
15
20
25
30
35
40
Years of Service


Annual Increment to Lifetime Benefits, net of employee contributions
(age 25)
120.00%
100.00%
80.00%
60.00%
40.00%
20.00%
0.00%
-20.00%
-40.00%
Tier 1
Tier 2
Cash Balance
0
5
10
15
20
25
30
35
40
Years of Service

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Summary

Common Elements to Federal, State & State Pension Policy

For current federal and state budget policy

Almost all spending growth going for pensions, health & interest payments

Explains failure to invest in children, workers, infrastructure, basic government

For future generations

Huge shift of burdens to younger generations

Whether through higher taxes, fewer benefits, or negative state employer pension contributions for new workers

For transparency

Continual political pressure to hide who will pay

Need for much better budgeting and actuarial accounting

No government entity reports on where net growth has gone or is going

No pension plan reports well how benefits relate to work in any one year

For our future

A rich nation growing richer …

That must first restore fiscal democracy to take advantage of its opportunities

Reports on Fiscal Democracy & State Pension Plans

Washington Post Article on 125% of Federal Revenue Growth Pre-Committed

Dead Men Ruling-Book

Fiscal Democracy in the States: How Much Spending is on Auto-Pilot

Public pension simulator

Urban Institute State and Local Employee Pension Plan Database

The State of Retirement: Grading America's State and Local Pension Plans,

Build Your Own Pension Plan,

Evaluating Retirement Income Security for Illinois Public School Teachers