



Economist.com

OPINION

Public-sector pensions

Unsatisfactory state

Jul 9th 2009 | LONDON AND NEW YORK
From The Economist print edition

As workers in the private sector are losing their final-salary pensions, public employees are being shielded from the true cost of provision for old age

Illustration by Belle Mellor



PENSIONS are expensive to provide. People are living longer, investment returns over the past decade have been dismal and interest rates are low. All this makes a given annual payment costlier to fund. In the private sector, employers are balking at the cost of defined benefit (DB) schemes, in which pensioners are paid a proportion of their final salaries. Many have been shut to new members or discontinued altogether. In Britain, closed DB schemes outnumber open ones by almost three to one.

In the public sector, however, final-salary schemes live on. In part this may be because of a conscious decision to reward workers in vital services such as the armed forces and the police. However, it may also be because the true cost of those pension promises is not being properly allowed for. "Governments are not accounting for what they have promised in the past and are understating what workers are being promised for the future," says John Prior of Punter Southall, a firm of actuaries.

Public-sector schemes face broadly the same costs as private ones. Government employees are living longer, just as private-sector workers are, and their wages are rising too. But the cost is being disguised, not tackled. This has two consequences. The first is that the public sector is building up an immense future liability that the next generation's taxpayers will be required to meet. The second is that public employees are getting a much better deal than their private-sector counterparts—even if the government is not accounting for it. In Britain the gap may amount to 30% of salaries.

Although pension schemes differ from one country to another, many governments are facing similar problems, even if they do not acknowledge them. But the gap between the public and private sectors seems widest in America and Britain. The strain is already beginning to tell. The British government is suggesting that local councils may be given leeway in deciding how fully they should fund their pension schemes. If they had to

eliminate their shortfall, taxes could soar. In America, state and local DB plans have seen the assets in their funds lose \$1 trillion in value since October 2007.

In Britain some national schemes are “unfunded”: that is to say, the government does not put aside a specific pot of cash to meet its liability to its employees. Instead, it vows to meet the cost out of future taxation. Such “pay-as-you-go” schemes, as they are known, are rather like the pyramid schemes made famous by Charles Ponzi, a 1920s swindler, in that they need a continuous stream of new investors to meet the claims of the old ones. (Of course, many basic state old-age pensions work in the same way.)

Other schemes, particularly those on offer from local governments, are funded rather like a company pension scheme. Contributions from employers and employees go into a pot, which is used to buy assets—shares, bonds and so forth. Over the scheme’s life the income from these assets is used to meet the pension payments.

You can quibble about whether there is truly an economic difference between funded and unfunded pensions when, for example, funded American government schemes put money into Treasury bonds. Such schemes still depend on future taxpayers to pay the interest (and repay the capital) on the bonds. There is also something rather odd about the government issuing bonds with one hand and buying them with another—in effect, borrowing from itself. But with a funded scheme it is at least easier to account for the cost.

If a private-sector final-salary scheme runs short of money, it is up to the employer to make higher contributions. In theory the cost may eventually overwhelm the company, which is why both Britain and America have insurance schemes designed to protect workers if employers default. But public-sector pension schemes are generally exempt from the same accounting and regulatory pressures as their private-sector counterparts. In Britain, for example, the Pensions Regulator cannot force the government to top up its contributions, as it can with companies.

That makes it important to account properly for the cost of public-sector pensions. In cash terms, the answer is simple; add up the payments being made to pensioners and subtract the contributions coming in from employers and employees. But that ignores the cost of the promise of future benefits to those still in work. In most schemes, the number of existing and deferred employees (those who have left but are still owed a pension) far exceeds the number of pensioners.

Because these promises fall due only in the future and because \$100 now is worth more than \$100 in a year’s time, they need to be discounted to calculate their present value. The choice of discount rate is crucial. The higher the rate, the lower the apparent size of the liabilities—and the size is highly sensitive to the assumed rate.

What is the right rate? In America the Government Accounting Standards Board requires public DB plans to estimate their liabilities with a rate that reflects the expected return on their assets. The average rate they use is 8%.

Allowing states to use their expected rate of return potentially encourages investment in riskier, higher-yield assets. In a paper last year Robert Novy-Marx and Joshua Rauh, of the University of Chicago, found that if states put their pension assets into a highly geared S&P 500 exchange-traded fund (an extremely risky portfolio), the implied discount rate would yield a “surplus” big enough to pay off all outstanding state bonds and provide a \$5,000 dividend to every American citizen.

From an economic perspective, using the expected rate of return makes little sense. The liabilities will not go away if the expected rate of return fails to materialise. Instead, pensions can be thought of as bond-like liabilities, requiring the employer to make a series of payments far into the future. In the private sector, companies are required to discount their liabilities by the yield on AA corporate bonds; the rate reflects the cost of their borrowing and allows for the possibility that the company defaults on its promise.

Although companies may default, it seems odd for a government to make pension promises and then use accounting methods that assume it may fail to keep them. In America, for example, state and local pension benefits are guaranteed by law in many states. That suggests the discount rate should be the Treasury bond yield, considered the risk-free rate.

Mr Novy-Marx and Mr Rauh (who is now at the Kellogg School of Management at Northwestern University) estimated the accrued liabilities of the 116 largest state and local-government pension plans using the

risk-free rate. They found the plans were underfunded by \$3.12 trillion, more than three times the states' estimate. This figure dwarfs the states' combined municipal debt of \$940 billion.

Even on the generous existing accounting basis, the funds look short. Alicia Munnell, director of the Centre for Retirement Research at Boston College, believes that before the credit crunch most public plans were well-funded on that basis—meaning that their assets covered more than 80% of their liabilities. But now she thinks the average plan has a funding level of just 65%.

In Britain the vast majority of central-government schemes are unfunded. This includes those covering the National Health Service, the civil service, teachers and the armed forces. The government charges departments a notional amount each year to cover the increase in future liabilities. In calculating this charge, it uses a discount rate of 3.5% after inflation.

This rate is hard to justify. It cannot be the expected return on assets, since the schemes have no assets to invest. Indeed, when the government calculates the cost of pensions for other purposes, it uses a different rate, which varies from year to year but is now 2.5% in real terms.

Even this may be too high. As a report by the British North-American Committee (BNAC), a group of businessmen, academics and parliamentarians, points out, when a scheme is unfunded, the employer is, in effect, avoiding the cost of borrowing the money to fund the plan. This means the right discount rate should be the cost of government borrowing. The BNAC argues that since British pensions are inflation-linked, the index-linked gilt yield is appropriate. This is only around 1% in real terms.

The BNAC reckons that, on the government numbers, British public-sector pension liabilities are 64% of GDP. At the index-linked discount rate, they are 85%. The difference is even more stark if one calculates how much the government should be charging departments for their pension schemes. At the moment, this charge is 18% of payroll; were it discounting at the index-linked rate, it would be 44% (see chart 1).

Are the BNAC's calculations realistic? Some, including Paul Samuelson, an eminent American economist, would argue that the ability to pay public-sector pensions derives from the power of the government to levy taxes, which in turn is limited by the rate of economic growth. That may be 2-2.5% (real) in Britain, which would produce a much lower figure for pension liabilities than the BNAC estimate. But the future economic growth rate is unknown, whereas the bond yield is set by the market every day.



One test of the pension cost comes from the Bank of England's funded DB pension scheme, which slipped into deficit in recent years. The bank has decided to invest purely in index-linked gilts (so assets and liabilities are matched). Its contributions have risen from 41% to 54% of payroll as it tries to eliminate the shortfall.

Outsourcing of public services creates another useful test. When British workers are transferred from the public to the private sector, their pension rights are shifted with them. The Confederation of British Industry, an employers' organisation, says that private companies find their pension costs are around double those allowed for by the public sector before transfer. The discount rate is not the only reason. Governments also underestimate the longevity of their employees.

In America, the full cost of final-salary pension promises may also be understated. The BNAC report estimates that for all American public-sector schemes (federal and local), the assumed contribution rate by employers is 18% of payroll. If the Treasury yield were used as the discount rate, that would rise to 29%.

Public versus private

The result of all this is that the total benefits of public-sector workers differ significantly from those of employees in private-sector companies. Around 4.9m British public employees are in open DB schemes, compared with just 1.3m private-sector staff. Around 85% of public employees are members of a pension scheme of some sort, against only 40% in the private sector. Among low-paid employees—earning between

£100 (\$160) and £200 a week—20% of private-sector workers are in a scheme, compared with 70% in the public sector.

If private-sector workers do get a pension, they are now more likely, especially if they are new to a job, to be in a defined contribution (DC) scheme, where the final pension depends on investment performance. This is clearly more risky from the employee's point of view than a guaranteed proportion of final salary. Furthermore, employers tend to pay in less: around 6.5% of payroll. Although DC employees chip in a further 2.7%, less than the typical contribution of a public-sector worker, that still means the public employee is benefiting from much higher deferred pay (which is what a pension is) than his private-sector counterpart.

The gap is hard to measure because some public-sector schemes are unfunded. But the BNAC estimates that the implied gap in benefit rates is as much as 30% of salary. The Pensions Policy Institute (PPI), a think-tank, using a different discount rate, calculates a gap of between 10% and 30% (see chart 2).

This should be allowed for when private- and public-sector pay rates are compared. In Britain the mean private-sector salary in 2008 was £27,408, against £23,943 in public service. But the mean is inflated by the high wages of investment bankers and so forth. The median public-sector employee is better paid. Once you allow for pension rights, he is even further ahead.

A further disparity is that public-sector workers tend to retire young. The average retirement age for state workers in Ohio is just 57. The normal retirement age for many plans is less than 62, and workers become eligible for retirement at 50. Fire-fighters and police officers often are able to retire with full benefits, sometimes on as much as 90% of their final salaries, before reaching middle age.

Normally, DB plans adjust benefits for early retirement so benefits are lower. But states often limit the size of those benefit reductions. That means taxpayers can subsidise early retirement for public employees. It stands in stark contrast to private-sector workers with DC plans, who will now probably end up working longer than they had anticipated.

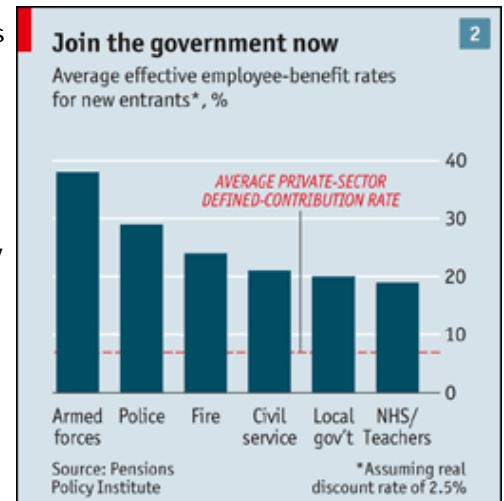
Paying the bill

Trade unions tend to regard such arguments simply as an excuse to attack poorly paid public-sector workers. In Britain the Trades Union Congress points out that the average pension received by ex-local government workers is a mere £4,000 a year. The answer to the disparity between private- and public-sector pensions is to upgrade the former, not downgrade the latter, in the unions' view.

They also regard the question of the discount rate as an accounting chimera. The government does not have to meet its full pension liability upfront. What really counts is the cash cost of meeting pension benefits. The PPI estimates that the cost of paying for unfunded British national schemes will rise from 1% to 1.4% of GDP by 2027-28. That sum involves a lot of guesswork about the future size of the public sector, pay, longevity and GDP growth, but it sounds a lot more manageable than the liability of 85% of GDP cited by the BNAC. Some independent experts, such as John Hawksworth of PricewaterhouseCoopers, an accounting firm, also think the current cost is more important than the present value of the future liability.

Trade unions are also opposed to raising the retirement age for public-sector workers. They feel this is particularly unfair for the lower-paid, who tend to have shorter life expectancy. Indeed, raising the retirement age is far from the whole answer. Benefits would be paid over a shorter period, cutting the cost of a pension, but more benefits would accrue with more years of service, raising it. Mr Rauh estimates that increasing the normal retirement age in America by one year would reduce expected liabilities by just \$200 billion, a smallish sum next to the total.

Switching to DC schemes would help reduce costs, although it would be unpopular with employees. Michigan and Alaska are the only states that offer only a DC plan to new staff. Indiana and Oregon require employees



to participate in both a DC and a DB plan, and eight states allow a choice between the two types. Even a complete move to DC plans for all future pension entitlements will not reduce the cost of promises already made.

The absence of a painless solution may simply encourage governments to push the bill further into the never-never. The British local-government ministry sent a consultation letter to local authorities last month. In a section headed "a possible new approach to solvency", it suggests authorities may be given "flexibility" about whether even to aim for a funding level of 100%. Private-sector companies are not allowed such flexibility.

Illustration by Belle Mellor



At the last reckoning in March 2007, the assets of British local-authority schemes were reckoned to be worth 84% of liabilities (in present-value terms). Given market movements since then, Watson Wyatt, a firm of actuarial consultants, estimates that the funding level may have fallen to 50-60%. Even repairing that deficit over 20 years would require pension contributions of around a third of council-tax revenues, meaning big cuts in services or big increases in tax. Unsurprisingly these are things the government is anxious to avoid.

In America Norm Jones, an independent actuary, reckons that if the stockmarket does not return to pre-crisis levels in a few years states will have to make big contributions to restore their plans to healthy funding levels. Some may need to receive injections of 50% of payroll. In many states, by law, employees' contribution rates may not be raised, nor their benefits cut. That places the burden on taxpayers.

This will not happen overnight. When states estimate funding levels, they typically take a five-year average of the market value of their assets. They can also amortise their unfunded liabilities over 30 years. So contribution rates will probably not rise until 2011, and then only gradually.

All that is achieved by such machinations is to increase the potential tax bill of future generations—the same generations that will also have to pay higher health-care and pension costs of their own, and meet the interest bills on the government deficits being run up in the face of the credit crunch. It is not much of a legacy.

Copyright © 2009 The Economist Newspaper and The Economist Group. All rights reserved.