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The Burden of Pensions on States

By MARY WILLIAMS WALSH

For public workers in Wisconsin, there's more bad news.

Having lost the battle on collective bargaining, they may soon be asked to make more financial sacrifices.

The state's workers offered to start picking up part of the cost of their pensions and health insurance early in their showdown this year with Gov. Scott Walker. That change will provide immediate relief for struggling towns, school districts and state agencies, and help them balance their budgets.

But new pension cost estimates, ordered before Governor Walker was elected, are coming as soon as next week. They are expected to show that the current contribution levels to the state pension system are too meager. More money, from employers and employees in some combination, will be needed, and perhaps much more in coming years.

Other states will also probably find that Wisconsin's idea of simply dividing pension contributions between labor and management is an illusory solution to their long-term financial woes. That's because several studies have shown that promises to workers are far more costly than routinely calculated by Wisconsin and most states.

And the problem seems unlikely to be solved by putting curbs on the collective bargaining power of state workers. Despite the arguments of some Republican governors and popular perception, the places with the most unionized work forces are not necessarily the ones with the most generous pensions, according to a new study.

Coming up with bigger contributions to pension funds will require states to make difficult choices about the size of their work forces, their commitment to public services and the viability of their employee benefits, which are often said to be irreversible and protected by state constitutions.

"The amount they have to be contributing could potentially be two to three times as much as they're contributing now," said Joshua Rauh, an associate professor of finance at Northwestern University, who has been challenging the way most cities and states measure their pension promises. "If you don't want to count on the stock market to pay for all this, this is what you're going to have to contribute."

Mr. Rauh and a number of other analysts say the states' biggest problem has been a failure to understand how much benefits will really cost. Instead of the states' models, these analysts have come up with alternatives that more closely approximate those used by insurance companies.

Unlike recalcitrant states like New Jersey and Illinois, Wisconsin has been setting aside money every year for its fund. It has also been thinking of lowering its reliance on stocks, to reduce its exposure to bear markets.

The issue is whether it has been setting aside anywhere near enough, given the magnitude of its promises to workers.

The idea that public pensions may cost more than expected angers many union officials. They say economists like Mr. Rauh are trying to frighten workers, or build resentment among taxpayers so that public pension funds will be scrapped and replaced with something less generous.

“We think there’s an agenda,” said Steve Kreisberg, research director for the American Federation of State, County and Municipal Employees. “These numbers have become intensely politicized, and they’re being distorted in a way that does real harm to real people.”

A spokesman for Wisconsin’s governor said Mr. Walker had not factored any possible increase in pension contributions into his budget proposal or talks with the unions. “That was never discussed,” said the spokesman, Cullen Werwie.

An analysis being prepared for the state agency that operates Wisconsin’s pension system — and which is to be presented to the agency’s board on Wednesday — is expected to show that it has been relying on too high a figure for investment gains. If the system’s trustees accept those findings, overall cash contributions will have to rise.

The actuary preparing the analysis is not tipping his hand, but any increase at this point is likely to be small. The state estimates that 12 percent of all public workers’ pay will need to be set aside annually for the pension fund. Lowering investment expectations sharply, to 7 percent a year from the current 7.8 percent, could push the contribution rate up to perhaps 16 percent, meaning an additional $2,000 to $3,000 a year apiece for workers nearing retirement.

Based on the 12 percent figure, workers agreed earlier this year to contribute 5.8 percent of their pay to the pension fund, leaving their employers to pay the remaining 6.2 percent. Workers also agreed to cover a portion of their health costs. How to pay for health benefits for retirees is still being discussed.

Workers in Wisconsin point out that their payments in retirement are hardly a king’s ransom. Their average annual benefit is about $26,500, and they believe they have been wrongly portrayed as greedy chiselers who game the system and walk away with six-figure pensions.

But it can be a huge burden for states and municipalities to provide even a modest, $26,000-a-year pension to hundreds of thousands of people, at least in today’s economic environment, and especially if those people are able to retire well before 65 and collect that money for many years.

“When interest rates are low, these plans are really expensive to run,” said Gordon Latter, an actuary at RBC Global Asset Management (U.S.) Inc., (formerly Voyageur Asset Management) whose clients include both corporate and public pension funds.

Despite the furor in Wisconsin, collective bargaining does not appear to be the main factor driving pension costs higher.

Sylvester J. Schieber, an economist and independent consultant, recently compared public pensions in each of the 50 states, ranking them from richest to poorest. Instead of looking at dollar values, like Wisconsin’s $26,500 a year, Mr. Schieber looked at what part of the average worker’s paycheck his pension was designed to replace in retirement. The method eliminates regional disparities and certain other problems with benefit-cost data.

Mr. Kreisberg of the public workers union said he considered the approach fair.

Mr. Schieber said he expected to find that the most generous states were the ones with collective bargaining for public workers, but he found no correlation whatsoever. “I was surprised at the result,” he said. “I had expected that the unions would be a significant force.”

Wisconsin turned out to have the eighth-richest pensions of any state, replacing on average 57 percent of a worker’s pay in retirement. But the most generous state by far is Colorado — even though it has granted collective bargaining to only a fourth of its public work force. In Wisconsin, roughly half are covered, according to Unionstats.com, a database that uses Census data to track union membership.

Colorado offers pensions that replace 90 percent of salary, with generous annual compounding that more than keeps up with the current rate of inflation. (The state has tried to reduce this compounding; retirees have sued.) Colorado’s pensions are unusually rich because its public workers are not permitted to participate in Social Security — the state pension is the only one they get.

The second-richest state is New York, which replaces 77 percent of a worker’s income, even though New York’s public work force earns Social Security benefits as well. A New Yorker’s public pension benefit, combined with Social Security, replaces more than 100 percent of his pay, Mr. Schieber found.

That might appear to be the fruits of collective bargaining, since New York State grants that right to more of its public work force than any other state. But the third most generous state is Georgia, replacing 68 percent of a retiree’s former paycheck on average. And Georgia is a right-to-work state with one of the lowest rates of collective bargaining in America, just 14 percent of its public work force.

Nonunion Georgia’s public pensions are, in fact, three times as generous as those of labor-friendly Vermont, where more than half the public work force has collective bargaining. Vermont replaces just 20 percent of a retiree’s previous pay, the lowest of any state.

Mr. Schieber said he was at a loss to explain these findings. He had expected rich pensions would go hand in hand with collective bargaining.

But his research, to be published in the Journal of Pension Economics and Finance, does shed light on how a seemingly modest $26,000-a-year pension can be considered unaffordably rich. One reason is low interest rates; another is that public employees can often start claiming their pensions in their 50s. Wisconsin's pension plan allows people to retire at 57 with a full pension, as long as they have 30 years of service. Police officers and firefighters can retire at 53, with 25 years of service.

In the private sector, pensions like that "have just kind of dropped off the radar screen," Mr. Schieber said. At the dwindling number of companies that still grant full pensions below age 65, people seldom take them, for fear of giving up their health insurance before they qualify for Medicare. Labor statistics show a marked increase in the number of 60- to 65-year-olds still working.

Public employees have so far dodged that bullet. They can still generally retire several years younger, which means their states or municipalities must pay their benefits over a longer period. That adds up. It also means the money for their benefits has fewer years to compound, so more must be set aside years in advance.

"By the time the typical private-sector worker has retired, the teachers, the highway patrolmen and these folks have already gotten $200,000, $300,000, $400,000 in pensions," Mr. Schieber said. "Plus, they're getting a pretty rich retiree health benefit. That's why these benefits are so expensive. "