Pensions in the Public and Private Sectors

Jeffrey R. Brown

College of Business at Illinois

Employee Benefits are an Important Part of Compensation

- Let's start with the "Naïve Comparison"
- According to 9/08 BLS data, benefits are higher fraction of compensation in the public sector:

	Employer cost of benefits / hour worked	% of total compensation
State & Local	$13.41	34%
Private industry	$7.93	29%

What Accounts for the Differences?

- Where does the extra $5.48 of benefits per hour go?

  $2.28 to health benefits ($4.21 vs. $1.93)

  $2.12 to retirement benefits ($3.09 vs. $0.97)

  The rest to all other benefits
- Differences arise for multiple reasons …
  - Higher fraction of workers covered by pensions and health insurance
  - More generous benefits conditional on coverage

Methodological Caveats

- In a competitive labor market, higher benefits are offset by reduced wages
  - There may be differences in the *form* of compensation, but there should not be persistent differences in levels (once everything is taken into account)
- Numerous observable differences in job characteristics between public and private sectors
  - Ideally, one would compare compensation packages holding constant other job characteristics
    - For example, benefits for a finance professor at the University of Illinois (public) versus a finance professor at Northwestern
- But even then, many differences that are hard to quantify, but very important none-the-less
  - Job security (civil service, unionization, faculty tenure, etc.)
  - Pension security (e.g., the Impairment Clause of the Illinois state constitution)
- **In general, it is extremely important not to draw *general* conclusions about total compensation generosity across sectors from *partial* comparisons …**

Pensions

- Some basic terminology:
  - Defined Benefit (DB) pensions
    - Employee is typically provided a benefit stated in terms of monthly income for life
    - Employer makes investment allocation decisions
    - Employer bears the funding risk (returns, inflation, longevity)
  - Defined Contribution (DC) [Examples: 401(k), 403(b)]
    - Employer provides contributions - no guarantee of benefits
    - Employee typically makes investment decisions from a set of options selected by plan fiduciaries
    - Employee bears the funding risk

Pension Trends

- Overwhelming trend over past 3 decades in the private sector has been the shift from DB to DC
- We are on the verge of another shift
  - "Income oriented DC plans"
  - Risk carried by 3rd parties (insurers, investment managers) rather than employer or employee
- Public sector is still a DB world
  - About 90 percent of 16 million state/local workers are covered by DB plans
  - Ex: STRS and SURS in Illinois
  - Note: DB can be more ***or*** less generous than a DC

Other Pension Differences

- According to a 2001 EBRI Report, 60% of *part-time* state and local workers receive pension benefits
  - Pension coverage is rare for private part-timers
- According to NASRA, about 2/3 of public pensions have automatic COLA's
  - These are much less common in private sector
- Public sector pensions often have generous early retirement provisions (e.g., retire with full benefits after X years of service, at much younger ages)
- Public sector definition of final average salary often includes fewer years (which tends to raise average benefits)
- Public sector earnings of approximately 1 in 4 state and local workers are not covered by Social Security
  - Public pension is therefore replacing both Social Security and a private pension

Important DB Funding/Risk Differences

- Private sector DB plans fall under ERISA funding rules and are insured by the PBGC
  - Private sector plans are substantially under-funded
  - Long-term fiscal pressure on PBGC
  - Accrued benefits only insured up to $54k per year
  - Plan sponsor has flexibility to alter future benefits
- Public sector plans are not subject to ERISA and are not backed by the PBGC
  - Illinois pensions are substantially under-funded
  - Participant benefits cannot be impaired → so the risk is on the taxpayer, not the pension participant

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The $64 Billion Question … Are these Plans Too Expensive?

This question is not easy to answer …
(and both sides have legitimate claims)

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No: “Public Pensions are Not Too Expensive”

- Public employees operate in a reasonably competitive U.S. labor market, so generous benefits offset with lower wages
- In Illinois, pension must replace Social Security and private pension, so of course it must be more generous than private pension
- The growing gap between public and private DB coverage reflects decline in private sector rather than growth in public sector
- The unfunded liability hanging over the state of Illinois is primarily due to many decades of inadequate funding by the legislature

Yes: "Public Pensions are Too Expensive"

- The Impairment Clause of Illinois constitution should be extremely valuable to employees as it effectively transfers all funding risk to the taxpayer. Thus, total compensation should be less generous to reflect this.
- Complexity / lack of understanding means that benefits may be more generous/expensive than fully appreciated by policymakers, taxpayers, or participants
  - Examples:
  - SURS participants implicitly benefit from equity returns while the taxpayers bear the risk
  - SURS provides implicit large subsidies to annuity rates
  - Misguided GASB rules understand the true economic cost of pension liabilities for all public plans

Looking to the Future in Illinois

- Our unfunded public pension obligations are enormous
  - SURS and TRS were already underfunded, and lost a combined $17 billion in 2008
  - Funding ratios currently stand at approx. 42%
  - True funding ratio (using economically appropriate assumptions) is far worse
- State Constitution prohibits benefit cuts, so this shortfall must be funded by tax revenue
- Implications:
  - Future tax rates will be higher
  - Further increases in benefit generosity should be avoided
  - The pension system for *future* employees should be periodically reviewed to ensure that risk-adjusted total compensation is competitive (but no more so) with private sector