



# Pension Woes May Deepen Financial Crisis For States

by Tamara Keith  
March 21, 2010



Over the past several decades, many states and local governments made pension promises that will be expensive to keep. Now, they're struggling to fund their obligations.

There's a looming U.S. financial problem that's big, is getting larger and could threaten the solvency of some states. From Connecticut to California, pension funds for teachers, firefighters and other public employees are severely underfunded.

"Generally, they're in an abominable state," says Joshua Rauh, an associate professor of finance at the Kellogg School of Management at Northwestern University.

A recent report from the Pew Center on the States put the tab for unfunded pension liabilities at \$452 billion. But Rauh and others say pension funds are using unrealistic assumptions about investment returns, meaning the pension funding hole is likely much deeper.

"Our calculation is that it's more like \$3 trillion underfunded," Rauh says.

And the kicker is that taxpayers are on the hook.

## **Stuck With The Bill**

"People say, 'Well that's ridiculous. We're just not going to pay it. Let [the pension funds] go broke,'" says Robert Gentzel, policy director for the Pennsylvania State Employees' Retirement System. "That's not what would happen. The taxpayers are ultimately going to have to pay the bill."

That's because public employee pension funds are backed by the full faith and credit of the government. Over the past several decades, many states and local governments

made pension promises that will be expensive to keep. Now, they're struggling to fund their obligations.

Take Cranston, R.I.

"Right now, the unfunded liability is \$240 million," Cranston Mayor Allan Fung told NPR's Jim Zarroli. That's more than double the city's annual budget.

Fung added, "It's a big obligation, and it's basically a ticking time bomb for the city of Cranston that we are trying to get a handle on."

### **Underfunding Becomes Next Generation's Problem**

The Pew report found state pension obligations nationwide were 84 percent funded. That doesn't sound so bad, but that figure does not include the full impact of the 2008-2009 market collapse, which hit pension funds hard.

Disappointing returns isn't the only funding challenge pension funds face. Many local and state governments haven't been putting enough money into the funds. When budgets are tight, shorting pension funds is a lot more politically palatable than raising taxes or having to make painful cuts.

"Underfunding is very easy because all you're doing is making this the next generation's problem," says Rick Dreyfuss of the free market-oriented Commonwealth Foundation in Harrisburg, Pa. "The next generation doesn't understand the magnitude of this, and they're too young to vote, so there's not a lot of political opposition to that."

Dreyfuss says there's a high political rate of return for increasing benefits, and there's basically no political upside to actually paying for those benefits.

### **Playing Catch Up**

This table shows how many years it would take for each state to make good on its pension promises if it spent all its tax revenue on pensions -- and nothing else.

<b>State</b>	<b>Plans analyzed</b>	<b>Assets (in billions)</b>	<b>Years to catch up</b>
Ohio	5	\$115.6	8.7
Colorado	1	29.3	8.3
Rhode Island	1	6.0	7.7
Illinois	4	65.7	7.2
Alabama	3	22.3	6.4
Wisconsin	1	62.2	6.3
South Dakota	1	6.0	6.0
Missouri	3	27.0	5.8
Mississippi	3	15.1	5.7
Oregon	1	46.1	5.7

**Notes:**

Pension assets are taken from *Pensions and Investments* for September 2008 and projected forward to December 2008 using asset allocation data and realized asset class investment returns. Tax revenue data used to calculate the years of tax revenue each state would need to devote to pension funding to catch up on its pension promises is based on 2007 data from the U.S. Census Bureau Census of Governments. Pension assets and liabilities are aggregated to the state level.

*Source: Analysis of data by Robert Novy-Marx and Joshua D. Rauh from "[The Liabilities and Risks of State-Sponsored Pension Plans](#)" (PDF), *Journal Of Economic Perspectives*, Fall 2009*

\*State Pension Underfunding Before The Great Recession  
March 21, 2010