Statement before the United States House of Representatives

Committee on Oversight and Government Reform

Hearing on State and Municipal Debt

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Chairman Issa, Ranking Member Cummings, and Members of the Committee. Thank you for the opportunity to testify with regard to the financial and budgetary challenges facing state governments. My name is Andrew Biggs and I am a resident scholar at the American Enterprise Institute. However, the testimony I will deliver today is my own and does not reflect any institutional positions of AEI.

I will touch on three topics related to state government finances: pension financing; public employee pay; and state investment practices. All present challenges to state and municipal governments. But context is nevertheless required, as governments face different levels of challenges and have so far responded in different ways. Some states have maintained balanced or near-balanced budgets through the financial crisis, while others have run significant deficits. Some have responsibly funded their pensions even during difficult times, while others have fallen back on borrowing and accounting tricks. The differences arise from how hard different states were hit by the recession and how hard their elected officials worked to address their budget problems.

On average, the states currently borrow approximately 23 cents of each dollar they spend, equal to around 1 percent of GDP.[1] To be fair, the states are models of fiscal rectitude relative to the federal government, which borrows 39 cents of each dollar it spends.[2] But the states, which are governed by balanced budget rules and lack the ability to print money, are less able to run deficits with impunity.

Currently, New Jersey has the largest budget deficit of any state in the country at around 2 percent of state GDP. But within around 10 years, the Government Accountability Office predicts, states and local governments *on average* will face a structural deficit of around 2

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[1] Sources: Center on Budget and Policy Priorities; Bureau of the Census.

[2] Source: Congressional Budget Office.

percent of GDP, that is, deficits not driven by the business cycle but by the general mismatch between revenues and outlays.[3]

Stabilizing state and local debt levels, the GAO found, would require an immediate and permanent 12.5 percent reduction in all state outlay or an equivalent increase in state revenues. For context, the CBO calculates that closing the federal fiscal gap over the same time period would require cutting spending by 25.8 percent, meaning that all sectors of government are facing the need for a significant fiscal consolidation.[4] This implies that, should state and local governments encounter a true financial crisis, the federal government's capacity to help may be constrained.

While I remain hopeful that states can avoid any significant disruption, the world is a dangerous place and it is worrying that so many levels of our government remain financially vulnerable.

Pension financing

Financing for public employee pensions poses significant challenges. Many states and localities remain unable to meet their full required pension contributions. And, economists are almost universal in believing that the accounting rules governing current contribution rates significantly understate the plans' true liabilities. As bad as the current pension funding situation may look, the reality is likely far worse.

The GAO reports that funding for public sector pensions currently equals 11.8 percent of public sector wages, up from 9.8 percent of wages in 2009. The typical state devotes three to four percent of its budget to pension funding.[5] But, as I noted in recent testimony before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, current pension accounting practices allow plans to discount benefit liabilities that are guaranteed

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[3] Government Accountability Office. "State and Local Governments' Fiscal Outlook." April 2011.

[4] Congressional Budget Office. "Long Term Budget Outlook, 2010." August 2010.

[5] Munnell, Alicia H., Aubry, Jean-Pierre, and Quinby, Laura. "The Impact of Public Pensions on State and Local Budgets." Center for Retirement Research, SLP#13. October 2010.

by law using the expected interest rate on a portfolio of risky assets.[6] Economists are nearly unanimous in believing that this approach is both technically wrong and, from a policy perspective, dangerous.

According to economic theory as well as the practice of financial markets, the discount rate used to value a liability should reflect the relative risk of the liability, not of any assets set aside to fund the liability. As the Vice Chair of the Federal Reserve Board put it, "While economists are famous for disagreeing with each other on virtually every other conceivable issue, when it comes to this one there is no professional disagreement: The only appropriate way to calculate the present value of a very-low-risk liability is to use a very-low-risk discount rate."[7] Likewise, an article in the respected *American Economic Review* states that "Finance theory is unambiguous that the discount rate used to value future pension obligations should reflect the riskiness of the liabilities."[8]

If public sector pensions were required to use economically sound accounting rules, the cost of pension funding would rise from around 12 percent of employee wages to an astronomical 46 percent. [9] This latter figure represents the true value of the pension benefits being promised and the true burden being placed on the public. States reduce the *apparent* pension cost burden by

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[6] Biggs, Andrew G. Statement before the United States House of Representatives, Committee on Oversight and Government Reform, Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs. "State and Municipal Debt: The Coming Crisis? Part II." March 15, 2011.

[7] Kohn, Donald L., "Statement at the National Conference on Public Employee Retirement Systems Annual Conference." New Orleans, Louisiana, May 20, 2008. <http://www.federalreserve.gov/newsevents/speech/kohn20080520a.htm>

[8] Brown, Jeffrey R. and Wilcox, David W., "Discounting State and Local Pension Liabilities," *American Economic Review,* vol. 99, May 2009. See also Novy-Marx, Robert and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives* Vol. 23, No. 4 (Fall 2009), pp. 191–210.

[9] This figure is based upon a recent actuarial analysis of the Florida Retirement System under a range of discount rates. Robert S. DuZebe. "Study Reflecting Impact to the FRS of Changing the Investment Return Assumption to one of the following: 7.5%, 7.0%, 6.0%, 5.0%, 4.0% and 3.0%. Milliman. March 11, 2011. It is inclusive of the "normal cost" of pensions (the cost of benefits accruing in that year) and the amortization of unfunded liabilities from prior years.

investing in risky assets, but this merely increases the contingent liabilities borne by taxpayers should investment returns falter.[10]

The Public Employee Pension Transparency Act sponsored by Rep. Devin Nunes would require pensions to at least disclose these figures. We cannot take a "see no evil" approach to pension financing issues. The sooner we recognize these realities through better accounting rules the sooner we can address them.

Public sector pay

Public sector compensation has generated controversy in states around the country as governors and legislatures have sought to bring outlays under control. It is important that governments at all levels get compensation right. If public employees are paid less than those individuals could earn in the marketplace, government will be unable to attract the workers it needs. Alternately, if public employees are overpaid then resources that could be better used elsewhere are effectively wasted.

A number of recent studies conclude that state and local government employees are underpaid relative to what individuals with similar education and experience would earn in the private sector. One well-publicized study concluded that state and local workers nationwide receive total compensation, inclusive of benefits, about 7 percent *below* that paid in the private sector.[11] Other state-specific studies have reached similar conclusions for workers in Wisconsin, Ohio, New Jersey and other states.[12]

These studies accurately account for state employee salaries, which are on average around 8 percent lower than what these individuals would likely earn in the private sector, ranging from a

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[10] For a discussion of pension obligations as contingent liabilities, see Biggs, Andrew "An Options Pricing Method for Calculating the Market Price of Public Sector Pension Liabilities," *Public Budgeting & Finance*, forthcoming.

[11] Bender, Keith A. and John S. Heywood, "Out of Balance? Comparing Public and Private Sector Compensation over 20 Years," Center for State and Local Government Excellence and National Institute on Retirement Security, April 2010

[12] See Keefe, Jeffrey, "Debunking the Myth of the Overcompensated Public Employee," Economic Policy Institute *Briefing Paper* No. 276, September 15, 2010 and subsequent state-specific studies published by the Economic Policy Institute.

low of -22 percent to a high of +0.6 percent.[13] But these studies significantly understate public sector pension benefits, omit the value of retiree health care, and place no value on public sector job security. [14]

- Pensions: A recent actuarial analysis of the Florida Retirement System performed at the request of Gov. Rick Scott showed that to match the guaranteed benefits paid to public retirees, a private sector worker with a defined contribution plan would need to save 29 percent of his pay.[15] Public pensions' aggressive investing and faulty accounting not only hides their high costs, they also hide the true value of benefits paid to retirees. Adjusting for these factors would increase average public sector compensation by around 18 percent. [16]
- Retiree health: Most public sector employees become eligible for subsidized health care in retirement, a benefit that is increasingly rare and stingy in the private sector. Most public pay studies ignore the value of retiree health care, but it can be significant. The State of California's Department of Personnel Administration, in a website advertising the government as a potential employer, notes that a typical public retiree will receive almost $500,000 in government payments during retirement.[17] A Milwaukee school teacher receives even more generous retiree health coverage, whose cost is equivalent to

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[13] These figures are based upon data from the Census Bureau's Current Population Survey, where public and private salaries are compared after controlling for differences the respective workforces in education, experience and other earnings-related characteristics.

[14] For more details on these issues see Biggs, Andrew and Jason Richwine. "Are California Public Employees Overpaid?" Heritage Foundation Working Paper. February 24, 2011; and Biggs, Andrew and Jason Richwine. "Public-Sector Compensation: Correcting the Economic Policy Institute, Again." Heritage Foundation Backgrounder #2539. March 31, 2011.

[15] See DuZebe, Robert S.. "Study Reflecting Impact to the FRS of Changing the Investment Return Assumption to one of the following: 7.5%, 7.0%, 6.0%, 5.0%, 4.0% and 3.0%. Milliman. March 11, 2011.

[16] Since we lack data on the actual benefits retirees will receive in the future, most pay studies infer benefit levels using the contributions that employers make toward those benefits today. But if public pension accounting rules and aggressive investment practices allow plans to make lower contributions per dollar of future retirement benefits, this will understate the benefits that will actually be received by public sector retirees.

[17]California Department of Personnel Administration, "Total Compensation Survey–Benefits" at *http://www.dpa.ca.gov/tcs2006/benefits.htm#retireeHealth.*

a more than 20 percent salary increase in every working year.[18] While good national data does not exist, retiree health coverage likely adds roughly 7 percent to total public sector compensation. When pensions and retiree health are properly accounted for, state and local employees shift from being underpaid on average by around 7 percent to being overpaid by around 18 percent.

- Job security: While state and local employees have suffered far more from layoffs than federal workers, they continue to have job security that far outweighs that enjoyed by private sector employees. This job security is valuable by itself, and even more so if it protects a premium received through salaries and benefits. For a typical state/local employee, better job security is equivalent to around an extra 5 percent of compensation.

It is important to note that public sector compensation can vary significantly from state to state, meaning that state-specific analysis is necessary to deliver any hard policy conclusions. Nevertheless, the broad view that state and local employees on average are significantly underpaid is almost certainly false.

Financial implications

Public pension financing raises a distinct issue from contribution rates and benefit levels: the management of assets set aside to meet future benefit liabilities. In their search for higher returns, states and localities are increasingly shifting to riskier and more exotic investments. This not only increases their sensitivity to shifting market returns but, with the trend toward so-called "alternative investments," raises the possibility that governments are taking on risk that they do not fully understand.

For instance, New Jersey recently approved rules allowing its pensions to invest up to 38 percent of their holdings in alternative investments, versus the current level of under 17 percent. These

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[18] "Milwaukee Public Schools. Retiree Healthcare And Life Insurance Programs. Actuarial Valuation As Of July 1, 2009." Actuarial analysis performed by firm of Gabriel Roeder Smith and Company. June 25, 2010. Normal costs as listed on page 1 are adjusted upward by 25 percent to account for the higher cost of coverage purchased in the individual market. The individual vs group market differential is derived from Buntin, Melinda Beeuwkes, José S. Escarce, Kanika Kapur, Jill M. Yegian, and M. Susan Marquis, "Trends and Variability in Individual Insurance Products," *Health Affairs*, September 24, 2003.

investments, according to Wilshire, carry significantly higher risks than stocks.[19] But under current accounting rules, the risks of pension investments are literally ignored – they are not disclosed, and they do not factor into plan funding decisions. Indeed, in forthcoming research I calculate that public sector pensions have actually *increased* the risk in their target portfolio allocations since the financial crisis of 2007.[20] We should worry about states becoming like a late-night gambler, hoping to recoup prior losses by doubling down.

Recent market declines highlight the difficulties facing public pensions. According to the Federal Reserve, total public pension assets as of the beginning of this year were 8.5 percent below their pre-financial crisis levels. Making matters worse, public pensions generally assume that assets will earn 8 percent annually, meaning that pension assets are today 27 percent below their pre-crisis *projected* levels. It would require 11.5 percent annual returns from now until 2020 for assets to return to projected levels. Wilshire Consulting has estimated that public pension plans will return only around 6.5 percent annually over the coming decade, meaning it is entirely possible that things will get worse before they get better.[21]

In addition, a number of states have issued so-called "pension obligation bonds," in which states effectively fund their pensions with borrowed money. These bonds can appear attractive as they allow states to borrow at lower interest rates and invest using the higher interest rates assumed by their pensions.[22] In accounting terms, at least, they generate "free money." But this is nothing other than investing on margin, buttressed by accounting rules that make it seem as if risk does not matter. In the real world, some governments have found themselves on the losing end of pension obligations bonds, paying out more in interest than they made on the investments. New Jersey issued such bonds in 1997 and 1998, just prior to the dot-com market meltdown. Illinois

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[19] For instance, Wilshire's estimated standard deviation of annual returns for domestic equities is 16 percent while that of private equity is 26 percent.

[20] Biggs, Andrew G. "How Have Public Sector Pensions Responded to the Financial Crisis?" Prepared for "How the Global Financial Crisis is Reshaping Retirement Security." A Wharton School/Pension Research Council/Boettner Center Conference. May 5 and 6, 2011

[21] Wilshire Consulting (2011). "2011 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation." February 28, 2011.

[22] See Munnell, Alicia H. , Thad Calabrese, Ashby Monk, and Jean-Pierre Aubry. "Pension Obligation Bonds: Financial Crisis Exposes Risks." Center for Retirement Research. SLP#9. January 2010.

issued $10 billion in 30-year pension obligation bonds in 2003, on which it is likely to have lost money to date. But undeterred – or more likely, with few other options – Illinois issued additional pension bonds in 2010.

In short, state and local government finances are coming to resemble hedge funds, with the worrying exception that they are being run by elected officials rather than by hedge fund managers. For instance, in 2008, five southeastern Wisconsin school districts lost up to $120 million after issuing debt to invest retiree health funds in so-called "synthetic collateralized debt obligations," a case the SEC is now investigating on charges that the districts were misled. But this merely highlights that as state and municipal investments have become more sophisticated – public sector pensions are in fact the largest single investor in hedge funds – governments ignore many of the fundamentals of what these investments are intended to do, which is to secure guaranteed benefits to current and future retired public sector employees. State and local investment funds have significant expertise on the asset side, but make almost no attempt to apply that expertise to asset-liability management.

The increased risk state pensions are taking makes overall state finances more subject to the whims of the market. And, as we have seen, financial crises can come at unforeseen times and from unforeseen places.

Conclusion

Lawmakers around the country can turn state and municipal finances around, just as lawmakers here in Washington can turn around federal finances. But time is a luxury that is growing short. While still mired in a recession it is difficult to contemplate painful long-term reforms. But there is reason to believe that such reforms, if properly enacted, can generate new confidence among citizens, business and financial markets that American government at all levels has the capacity to get on top of its budgetary problems.[23] And, during an economic slowdown, renewed confidence is essential to a recovery.

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[23] See Biggs, Andrew G. "Statement before the United States House of Representatives, Committee on Ways and Means. Hearing on Impediments to Job Creation." March 30, 2011.

Committee on Oversight and Government Reform
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)(5)

Name: Andrew G. Biggs

1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2008. Include the source and amount of each grant or contract.

"The Treatment of Married Women by the Social Security Program."
Center for Retirement Research at Boston College through Social Security Administration. ($41,451)

"Improving the Social Security Statement."
RAND/Wharton/Dartmouth Financial Literacy Research Center through Social Security Administration. ($39,862)

"Exploring Alternate Ways to Express Estimated Future Retirement Benefits in the Social Security Statement."
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I certify that the above information is true and correct.
Signature:

Date: April 12, 2011

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2004-2008 M.Sc. financial economics, University of London

1992-1995 Ph.D. government, London School of Economics and Political Science

1991-1992 M.Phil. social and political theory, Cambridge University

1988-1990 B.A. philosophy (honors), Queen's University of Belfast

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Professional background

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2007-2008	Principal Deputy Commissioner, Social Security Administration
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1999-2003	Social Security Analyst, Cato Institute
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Recent Publications

Biggs, Andrew G. "An Options Pricing Method for Calculating the Market Price of Public Sector Pension Liabilities." *Public Budgeting & Finance*. Forthcoming.

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