Douglas J. Elliott
The Brookings Institution
May 12, 2011

Potential Federal Roles in Dealing with State and Local Pension Problems

State and local pension funds across America struggle financially. The aggregate state pension deficit ranges from $0.7 trillion to $2.5 trillion or more, depending on how one calculates the value in today's dollars of future pension payments. Pension deficits at localities add as much as another half trillion dollars. Whatever the true figure, this is a big problem -- funding this deficit immediately could require two year's worth of state and local tax revenue, or more. Put another way, the higher estimates for the deficit are about the same size as the total amount states and localities have borrowed from the bond markets. (A primer on state and local pensions and their funding is available at http://www.brookings.edu/reports/2010/1206_state_local_funding_elliott.aspx).

The magnitude and difficulty of these pension problems raise several interlinked questions, which this paper will address:

- Should the federal government intervene?
- What could it do to help?
- What key principles should guide any federal action in this area?
- In practice, would political constraints allow federal intervention?

Summary

There are reasonable arguments for a range of views and this paper tries to objectively present the different viewpoints and the positives and negatives of the potential policy options. In the end, the author personally believes that most states and localities do face very serious pension problems that need to be dealt with over the long-term. Some of them face such severe problems that near-term action is vital. However, it does not appear appropriate, for a variety of reasons, for the federal government to provide financial aid to the states, even through loans or guarantees. Rather, Washington should push states and localities to face up to the issues and strongly encourage, or possibly even require, substantially better and more uniform reporting, including the use of less aggressive accounting techniques.

Federal financial assistance is not warranted, because the problems are tractable without federal money and such aid would raise major fairness issues. The pension deficits vary considerably in size and, unlike with natural catastrophes, the most severely damaged states bear major responsibility for creating their own difficulties. In addition, there is a real danger that assistance would end up encouraging future irresponsibility, even if major restrictions were attached to the money.

Some of the proposed options are presented by supporters as nearly costless to the federal taxpayer. If we knew this to be true, such choices would almost certainly be worthwhile. However, they invariably are made to appear costless by implicitly or explicitly assuming that the worst case will not occur. This is not a safe assumption and the federal government should not be in the business of guaranteeing against all unlikely harmful events simply because there is a low probability of loss. Financial markets charge substantial sums to take such risks precisely because sometimes less probable events do actually occur and they can be very costly. We recently saw with Fannie Mae and Freddie Mac that years of providing a "costless" implicit federal guarantee of seemingly safe institutions came home to roost with losses to the taxpayers that are likely to mount to hundreds of billions of dollars.

The author is also not inclined to support proposals for a new section of the federal bankruptcy code to govern insolvencies of states, because there will almost certainly be substantial costs while the benefits are much less clear. The interest rates that markets charge states would inevitably rise if such a mechanism were created, since it would make it more likely in practice that states would default on their obligations. Although this cost increase would hit weaker states the hardest, it would likely fall on all states to some extent, since the rules of the game would be seen as different, and less attractive to investors. On the other side, it is not clear that states would actually find themselves in a substantially better position to deal with their financial problems. In particular, it is not obvious that a revised bankruptcy law would really provide new options that do not already exist for the states, for reasons explained below. However, there is a great deal of legal complexity in regard to this and there is still some room for a convincing case to be made for the new bankruptcy code.

Whether or not the author's opinions are correct, it is also improbable as a matter of practical politics that federal aid will be offered, for a variety of reasons explored below. It would therefore be dangerous for any of the parties involved in resolving the financial and pension problems of states and localities to assume that Santa Claus will arrive with bags of federal cash. Unfortunately, such a false hope appears to be one factor delaying needed adjustments in some of the states.

Should the federal government intervene?

There are several reasons for the federal government to care about how states and localities handle the pension challenge, such as:

A large part of the nation's population lives in states and localities which are likely to be forced to take painful actions, including Illinois, New Jersey, Ohio, and New York City. If there were an easy way for the federal government to help, it would benefit many of its citizens.

Some states and localities have particularly deep pension deficits that will warp civic priorities and local politics for years. The largest pension deficits are too big to shrink to a painless size simply through a rebound in the financial markets. Instead, they will force substantial cutbacks in government services, significant tax increases, or the refusal to pay previously promised benefits. Illinois, for example, recently made truly major changes in its taxes and service provision, in part as a result of severe pension deficits.

In addition to the financial effects, we have seen in recent months just how divisive painful fiscal actions at the state level can be. The depth of the pension problem, combined with the lingering effects of a terrible recession, has led some state leaders to take strong and controversial actions. Regardless of the appropriateness of these actions, the ensuing bitterness may end up having national political implications.

Further, the cumulative effects of actions across the country could be a major drag on the national economy. It has already been observed that state budget cuts triggered by the recent recession negated a significant portion of the stimulus provided by the federal government's spending increases and tax cuts. Pension problems could create an even worse, and longer lasting, drag in the future which could come at the same time as the federal government retrenches. Each of the main choices to deal with the deficits, (raising taxes, cutting services, or reneging on previous benefit commitments), depresses the local economy and, taken together, the national economy. Avoiding this downward pressure would clearly be worthwhile, all else equal.

There are also arguments against intervention:

Most forms of federal intervention would cost money and add to federal budget deficits. The majority of the options discussed in this paper either directly cost money or expose federal taxpayers to risk of substantial future loss.

States and localities vary considerably in the degree of challenge they face. Virtually all states face significant pension deficits, but the size varies greatly. Illinois' pensions, for example, are only 51% funded by assets held in the pension plans currently, even using reported figures. Using the most conservative discount rate, the plans would only be 28% funded[1]. Even at the more optimistic level, the underfunding is equal to 10% of the state's annual production of goods and services, a figure that rises to 27% on a more conservative basis. On the other hand, New York State actually has a very small pension surplus on a reported basis, although it is only 59% funded on the most conservative calculations, equivalent to 10% of state economic output. (Despite its relative strength at the state level, New York is often mentioned in connection with pension problems because there are very large deficits at New York City's pension funds, which are not included in the above figures.)

The deficits mostly vary because of state and local political choices. Both rational public policy and national emotions argue for aid to states that are hit with natural catastrophes. Dedicating national resources to local problems is much more controversial when the difficulties are self-inflicted. Illinois, to take but one example, has chosen repeatedly to let its pension problems grow. It often failed to fund even an amount equal to the new pension promises earned in a given year, and very seldom contributed

[1] Please see table 1 and Appendices A and B for the state-by-state figures. The "as reported" numbers were compiled by the Pew Center on the States. The adjusted figures reflecting the use of Treasury rates for the discount rates were calculated by Rauh and Novy-Marx, as noted in the table.

enough to even begin paying down its already significant pension deficit. Many other states were relatively disciplined about funding their promises, and about stepping up contributions to fill in for investment underperformance, leaving them with lesser problems.

Federalist principles argue for caution in intervening in state level decisions. When the states came together to create the federal government, they wrote a constitution that delegates certain powers to the national government, but reserves the rest to the states. The boundary has been altered over the years, but constitutional issues still place constraints on some of the proposed solutions. Moving beyond purely legal issues, there are also public policy arguments for respecting the federalist spirit by not forcing uniformity or intervening in state-level issues without a strong national consensus.

There is not one clear "right" answer to whether the federal government should step in, since balancing these complex pros and cons requires subjective judgment, often closely tied to ideological beliefs about the proper role of the federal government in the economy. The choice also depends on the available policy instruments.

What could the federal government do to help?

There are a variety of tools available to the federal government, principally including:

Direct aid to the states and localities. The federal government could increase its transfers to the states and localities, either specifically for use in pension funding or to relieve the totality of financial pressures, including that from pensions.

Lending funds to fill in the pension gaps. The federal government is a massive lender to the private sector and could certainly choose to lend to the public sector at the state and local level[2]. There would, though, be little point in doing this unless the federal government provided more favorable terms than would otherwise be available in the market. All of the states, and a large portion of local governments, can already borrow from bond investors or banks on terms that are roughly comparable to those available to most corporations. Offering federal money on similar terms would bring no particular benefit to the states. Therefore, the primary benefit of federal lending, if any, would be the subsidy provided by charging a lower interest rate than the market would.

Guaranteeing private lending to the states and localities. Most of the federal government's credit provision is arranged by guaranteeing that private lenders will be repaid, rather than having the government write the initial check to the borrower. The economic cost of such a guarantee is roughly equivalent to the economic cost of taking the credit risk directly by lending funds. In large part, the

[2] The author's forthcoming book, *Uncle Sam In Pinstripes: Evaluating the Federal Credit Programs*, will provide a comprehensive discussion of the federal role as a credit provider to the private sector.

federal government's budget methodologies reflect this equivalence, although there are some differences between the budget effects of lending and guarantees in practice[3].

Creating federal rules for bankruptcies by states. Some analysts and politicians concerned about state pension problems believe that it would be helpful to amend federal bankruptcy law to assist states in dealing with their creditors, particularly in regards to pension promises. Currently, federal bankruptcy law allows individuals, businesses, and local governments to use provisions of the Bankruptcy Code to restructure when they run into financial problems, but states may not do so. The US Constitution specifically gives Congress the power to legislate on bankruptcy, but it also leaves states with "sovereign immunity" as a general rule, which protects them from a wide range of lawsuits. As a result, states generally cannot be forced to pay their bills or transfer assets except under rules that they themselves devise and enforce[4]. This gives them the ability to perform a bankruptcy-like restructuring by deciding the timing and amount of payments to make on their bills, without the need to use federal law or procedures.

In recognition of sovereign immunity, the federal bankruptcy provisions for local governments explicitly give a veto to the state in which the locality exists, allowing it to block a bankruptcy proceeding from going forward. (This veto is not just theoretical, having been actively exercised in a number of cases, in addition to an automatic veto included in some state laws.) Further, that section of the bankruptcy code gives a federal bankruptcy judge much weaker powers than he or she would have over a corporate bankruptcy, including a prohibition on requiring actions that are effectively political in nature, such as decisions about raising taxes or cutting services.

Supporters of a proposed new section of the federal bankruptcy code to govern insolvencies by states agree that the federal government could not force a state into such proceedings. However, they believe that a state which chose to use federal bankruptcy law would be better positioned to deal with its creditors, especially those who have been promised pensions and healthcare in retirement that these supporters view as excessive. The strong form of the argument is that Congress has the constitutional right to create bankruptcy law and that once a state voluntarily chose to enter bankruptcy proceedings, federal bankruptcy law would pre-empt at least certain types of state laws. The weaker form of the

---

[3] See the author's detailed primer on federal budgeting for credit at http://coffi.org/pubs/Budgeting%20Primer.pdf. In a nutshell, the Federal Credit Reform Act requires that the budget cost of credit provision be calculated by projecting the future federal cash inflows and outflows related to the loans, calculating the value of each flow in today's dollars by discounting at the federal government's borrowing rate, and summing the resulting figures. Direct lending has large outflows up-front, as the loan is paid out, and large inflows over time as the loans are repaid, in addition to annual interest payments, fee revenues, etc. Guarantees eliminate many of the federal cash flows associated with direct lending, but the effect of credit losses still exists. It shows up as federal payments of guarantee obligations rather than as the difference between the value of the loan outflow and the partial repayments, if any, on the loan.

[4] Exceptions exist when other parts of the Constitution, such as those protecting civil rights, conflict with sovereign immunity. As an extreme example, a state could not choose to pay its debts to men, but not women, or vice versa. More realistically, the state of California, for example, has been required to upgrade its prison systems, at considerable cost, in order to preserve rights protected by the federal constitution.

argument is that such pre-emption might have constitutional problems, but that state governments themselves would have a much stronger political ability to take certain actions, and might be better positioned in terms of state laws and constitutions, because of the federal bankruptcy provisions. In general, the proponents are focused on the perceived need to change contract clauses related to pension promises and possibly other collectively bargained agreements. In sum, they believe a change in federal bankruptcy law could give states the legal and/or political leverage to force changes to previously agreed promises to their employees.

Opponents of a revision to the Bankruptcy Code generally make one or more of three types of arguments. First, some dispute the constitutional analysis, concluding that such bankruptcy changes would be negated by sovereign immunity provisions in the federal constitution. Put another way, they argue that anything the states could choose to do under bankruptcy law they could already do under other statutes and if they could not take an action now, they could not do it under cover of the bankruptcy code. Second, they may believe that the change would indeed increase the legal or political options for cutting back on pension promises, but believe that this would be bad public policy. Third, the existence of a bankruptcy code section for states would raise the cost of borrowing from the market, since it would be perceived to raise the default risk faced by investors in municipal bonds, as discussed further below. The added costs for all states could outweigh, in the aggregate, any benefits for states that chose to use the new section of the bankruptcy code.

Enforcing changes in the pension information provided by states and localities. As described at length in the author's primer on state and local pensions, a large majority of economists who have studied the issue believe that the current accounting rules for states and localities sharply understate the true size of pension promises. A significant number of actuaries and many other policy analysts share this view, as does the author. The core argument is that the future pension payments need to be discounted back to today's dollars at a more conservative, meaning lower, interest rate than implied by the current public sector accounting rules. (This would largely be in line with the modern accounting rules for private sector companies that have applied for the last couple of decades.) Using a lower rate means that more dollars are needed today to match the future promises. This is not just an academic distinction, it can make over a trillion dollars of difference in the calculated aggregate pension deficit. It is the principal cause of the disparity between the $0.7 and $2.5 trillion estimates for total underfunding at the state level.

Some members of Congress have already introduced bills to effectively force states to provide an alternative calculation using an interest rate based on US Treasury rates, which would be the most conservative rate to use. They would also require considerably more information to be disclosed about the financial condition of the pension plans, particularly the estimated future pension payments by year. The enforcement mechanism would be to cut off access to the public bond market to any state or municipality that did not provide such information. Losing that access would be a grave inconvenience to such borrowers, which generally rely on the municipal bond market for funding, and would likely lead them to provide the information.

An alternative route for the federal government to require greater, or different, disclosure would be to mandate the information as a condition of continued federal tax benefits for the state and local pension plans. These tax benefits are very large, indeed they are a main motivation for offering such pension plans, so this would also almost certainly cause the information to be released. Finally, the SEC has authority over the Government Accounting Standards Board (GASB) which is the body that sets accounting standards for US governments at all levels. The SEC could use such authority, or its persuasive powers, to push GASB to change how it accounts for pensions.

Federal actions to force additional disclosures, or to influence the required disclosures, would have the advantage of costing almost nothing. Further, as described in the primer, the current accounting rules and disclosures encourage a number of risky behaviors that have contributed to the massive deficits. On the other hand, federal requirements could conflict with at least the principles of federalism, if not necessarily with the actual constitutional and legal constraints. (One suspects, even as a non-lawyer, that there is sufficient federal authority in regard to disclosure in securities offerings, or in regard to tax-advantaged benefit plans, to allow federal intervention of this type without violating the US constitution.)

Provide PBGC protection to state and local employees and retirees. The Pension Benefit Guaranty Corporation (PBGC) was established in 1974 to guarantee that beneficiaries of defined benefit pension plans[5] sponsored by businesses would receive the full pension they had been promised, up to certain limits, even if their sponsor went bankrupt[6]. There has been some talk of expanding the role of the PBGC to provide similar protection to state and local workers in exchange for insurance premiums, such as they charge currently to the companies sponsoring insured plans.

One, among many, practical issues with this approach would be the question of how to price the pension guarantee. Charging a market price for this credit insurance would provide little net economic benefit to the states or their employees and would certainly be perceived by the states as exorbitant. The states with the worst pension deficits are generally being charged in the range of 2% a year by the financial markets purely for the potential default risk. A premium in this range charged on each dollar of underfunding would likely produce a cost that politicians would find unattractive and it would appear to put a federal stamp on the market's view that default is a real possibility, even if one of relatively low probability. Premiums below this level would effectively provide a subsidy for the riskiest states that would come either from the federal taxpayer or by over-charging the less risky states in order to produce sufficient revenue on average.

[5] These are the traditional pension plans that provide a monthly pension payment while retirees live or a lump-sum equivalent at the time of retirement. 401(k)'s do not fall under this category, but are referred to as defined contribution plans.

[6] See the author's primer on the PBGC, available at http://www.brookings.edu/papers/2009/0520_pensions_elliott.aspx

The PBGC's situation already provides a good example of the strong tendency for federal programs to undercharge for credit and market risks, as it has a quite substantial deficit that implies that the right premium levels historically were about twice the amounts actually charged for the risk taken on. The PBGC itself is not to blame for this, as Congress strictly retained the right to set the premium rates and chose to set them at a low and uniform level, a precedent that might easily carry over in this case.

What key principles should guide any federal action in this area?

If the federal government does act, it should do so in a way that is consistent with several key principles, including to:

Minimize "moral hazard". Moral hazard is an economic term referring to a situation where an insurance contract or a loan inadvertently encourages one side of the contract to create a loss for the other side. For instance, someone with a lot of insurance on a car they do not like anymore may be tempted to leave the doors unlocked. At the extreme, moral hazard can lead to arson and similar illegal actions. In this context, similar to concerns about the rescues of financial institutions in the recent crisis, the risk is that governments benefiting from a federal backstop might be encouraged to continue to generate pension deficits if the wrong approach is used. This would be a clear concern with the concept of having the PBGC provide protection for state and local workers and retirees. The existence of this protection, unless actuarially fair premium rates were truly charged, could easily lead state and local governments to reduce their pension funding even further. After all, there would be little pressure from the unions to adequately fund the pension trusts, once the benefits were protected another way. (For this reason, the creation of the PBGC was coupled with new federal mandates designed to ensure high levels of pension funding.) If federal taxpayers are exposed to significant risk, directly or indirectly, there should be concrete requirements that state and local governments act responsibly to reduce the pension deficits over time.

Explicitly calculate any costs and include them in the federal budget. Most programs where the federal government takes credit risk are explicitly shown on the federal budget with subsidy costs that are calculated, by and large, along lines similar to the best practices of the private sector and the recommendations of academics[7]. Any aid to state and local governments, even if the federal government's exposure is indirect, should follow these same principles and be carried on the federal budget. At the other extreme, it would be highly undesirable to mimic the approach used with Fannie Mae and Freddie Mac, where virtually everyone understood that the federal government stood behind the debt, but no cost showed up on the budget until the eventual blow-up, at which point we began to see taxpayer costs that could mount to several hundred billion dollars.

---

[7] The Federal Credit Reform Act governs how such programs are recorded on the federal budget. See http://coffi.org/pubs/Budgeting%20Primer.pdf for more detailed information. The author agrees with the majority of economists and other experts in this specialized area who believe that the budget cost should reflect an adjustment for the level of risk, rather than using Treasury rates which are effectively risk-free, but otherwise the current procedures are quite sound. Even with this remaining weakness, the rules are quite helpful in encouraging good decisions.

Minimize the extent of subsidies from "good" states to "bad". Unfortunately, almost any subsidy to aid states with pension problems involves a net cost to those states that have acted responsibly to avoid such woes. This could occur by over-charging the good states for the protection they are being given or by collecting federal tax revenue from all states but disproportionately providing benefits to those states that most need the help. As noted earlier, the federal government does provide relatively uncontroversial subsidies to victims of natural disasters, even though some states are at much lower risk over time for such disasters. The big difference is that natural catastrophes generally do not result from irresponsible actions by local governments. When they do, such as through the alleged overbuilding of beachfront property in some coastal states, the subsidies often do become controversial.

Focus on correcting market imperfections. There would be stronger arguments for federal intervention in situations where the private sector appears to be acting in uneconomic ways. For example, there was a period of extreme stress in the municipal bond market as a result of the larger financial crisis in 2008 and 2009. Almost no one seriously argues that the private markets were accurately determining prices based on true long-term economic values at that point, since panics, credit crunches, and liquidity problems of all kinds were clearly having a major impact. If supporters of federal intervention can legitimately point to some form of market imperfection, there is the potential for a net economic gain to result from federal action, as opposed to simply a redistribution of pain.

This emphasis on market imperfections does not rule out the potential for valid stimulus-type arguments that focus on spurring economic activity, even if there is a clear up-front cost to federal taxpayers. However, approaches aimed at stimulus should have to jump a higher hurdle before being accepted, given that there are many ways to encourage economic growth to choose among.

Enhancing information disclosure, described next, would be an important step towards eliminating some market imperfections that exist now.

Improve the quality of information available about pension plans. State and local pension plans are not subject to all of the same information requirements as corporate pension plans are. As a result, the data available to evaluate state and local plans is somewhat inconsistent and lacks sufficient detail. For example, these plans seldom reveal their estimates of their pension payouts year by year into the future even though this information is always assembled as a necessary part of the data used to calculate the value in today's dollars of those future payments. If legally and politically feasible, better information should be required, on a consistent basis, as a quid pro quo for whatever assistance the federal government provides. The author is among the many analysts who further believe that part of this improved information should be a calculation of the deficit under more appropriate discount rates, which would be more conservative than those currently used by state and local governments.

Information disclosure and accounting matter greatly, because voters and decision-makers rely on these figures to make decisions about the level of benefits they can afford to offer and the level of funding that is necessary to back those promises. The underlying financial flows are too hard to understand without key summary statistics, such as the reported figure for the pension deficit. Therefore, these

numbers take on outsized importance. Put another way, the use of a flawed map has, not surprisingly, led many states to drive to a place they did not actually wish to go.

Would political constraints allow federal intervention in practice?

In general, strong political obstacles are likely to severely limit any form of federal intervention over the next few years and quite possibly much longer, whatever the conclusions of public policy analysts as to their desirability. The key constraints are:

Politicians from "good" states are unlikely to want federal subsidies to be targeted to "bad" states. As with many federal spending programs, it can be very difficult to achieve the necessary majority vote without ensuring that the benefits are spread fairly evenly across the states. (The distribution of funding to protect against terrorism is a prime recent example.) This problem is exacerbated by the fact that the variation in the severity of state pension problems is almost entirely due to choices made by those states. It is true that pension funding in all of the states moves up or down in a similar manner based on how financial markets perform, since they tend to have broadly similar investment approaches. However, the states differ greatly in how seriously they have taken the need to contribute to their pensions and in the diligence with which they have considered the pension promises they made. It could be very difficult for a Senator from Wisconsin, which reports no pension deficit, to support federal pension aid that would go primarily to states such as Illinois which have not managed their situations as responsibly.

It generally takes 60 US senators these days to pass a controversial bill, since any lesser support would be insufficient to stop a filibuster. The following table shows the level of pension underfunding at the best-off 20 states, represented by 40 senators, one shy of enough to sustain a filibuster. These 20 states were chosen because they have underfunding that is better than the median level for all states both in terms of their reported funding ratio (assets divided by liabilities) and in terms of the size of the underfunding relative to the size of the state economy. The table also shows the figures on a more conservative basis, using Treasury rates to discount the future pension payments back to today's dollars. (Appendices A and B give more details on a state-by-state basis for all 50 states.)

It seems unlikely that Senators in these 20 states, all of which are at least 78% funded on a reported basis, would support federal aid that would primarily aid the less well-funded states. The disparity between the two groups, on a reported basis, is striking. The best twenty states have an average funding ratio of 88% compared to 67% for the worst thirty. For comparison, many observers use a rule of thumb that a state is okay if it is at least 80% funded, although there appears to be no strong analytical basis for this particular cut-off. Rather it simply seems to reflect the fact that a 20% underfunding can usually be made up over a period of years without prohibitively painful actions.

Looked at another way, the pension underfunding as a percentage of annual state economic production was just 2% for the best twenty states compared to 8% for the thirty worst. Again, this seems to suggest that the pressure for the better states to take strong action is relatively light and that they would be unlikely to support federal aid that would disproportionately go to other states.

This discussion has focused on the numbers on an “as reported” basis, because those figures are the ones most likely to shape the political debate, since they are based on the accepted existing accounting rules. However, if state and local leaders, or the voters to whom they respond, should shift their focus to a more conservative accounting approach, then the playing field would change. If Treasury rates were used for the discount rate, which is the most conservative approach, then all states appear in need of substantial action and many of them would find the remedies very painful without federal aid. However, it appears unlikely that the official accounting rules will change in this manner anytime soon and the political impact of “alternative” calculations is usually much less than the power of official figures.

Table 1 Funding Status of 20 Best-Funded States

	Funding Ratio Stated Basis	**Underfunding as a % of Gross State Product** (Stated)	**Unfunded Liability** Stated Basis ($ billion)	**Funding Ratio** Treasury Rates	**Underfunding as a % of Gross State Product** (Treasury)	**Unfunded Liability** Using Treasury rates ($ billion)
New York	**101**	**0%**	**-1**	**59**	**12%**	**133**
Wisconsin	**100**	**0%**	**0**	**51**	**23%**	**56**
Washington	**99**	**0%**	**1**	**50**	**13%**	**43**
North Carolina	**97**	**1%**	**2**	**63**	**9%**	**38**
Delaware	**94**	**1%**	**0**	**53**	**8%**	**5**
South Dakota	**92**	**2%**	**1**	**55**	**12%**	**5**
Tennessee	**90**	**1%**	**4**	**53**	**9%**	**23**
Wyoming	**89**	**2%**	**1**	**45**	**14%**	**5**
Nebraska	**88**	**1%**	**1**	**47**	**7%**	**6**
Georgia	**87**	**3%**	**10**	**48**	**14%**	**57**
Oregon	**86**	**5%**	**8**	**53**	**23%**	**38**
Utah	**86**	**3%**	**3**	**47**	**15%**	**16**
Florida	**84**	**3%**	**23**	**52**	**12%**	**90**
Texas	**84**	**2%**	**25**	**47**	**12%**	**142**
California	**81**	**5%**	**93**	**47**	**20%**	**370**
Iowa	**81**	**4%**	**5**	**51**	**12%**	**17**
North Dakota	**81**	**3%**	**1**	**43**	**11%**	**4**
Virginia	**80**	**3%**	**14**	**46**	**12%**	**48**
Missouri	**79**	**5%**	**12**	**44**	**18%**	**42**
Arkansas	**78**	**5%**	**5**	**48**	**15%**	**16**
Top 20 Average	**88**	**2%**		**50**	**14%**	
Bottom 30 Average	**67**	**8%**		**38**	**21%**	
All 50 Average	**76**	**5%**		**43**	**18%**	
Cumulative			**207**			**1155**
Pension Deficit Top 20			**207**			**1155**
Pension Deficit Bottom 30			**449**			**1331**
Pension Deficit All 50			**656**			**2486**

Source: Pew Center *The Trillion Dollar Gap Grows Wider,* Joshua Rauh and Robert Novy-Marx *Public Pension Promises: How Big Are They and What Are They Worth?* , October 2010, Journal of Finance

Conservatives are unlikely to support a pension “bailout.” Conservatives generally conceive of the state and local pension problems as being the result of excessive promises made to public employee unions, which is why several Republican governors have recently tried to revoke or limit the bargaining power of state unions. Given this view, most Republican members of Congress appear to be adamantly opposed to federal pension aid. Consistent with these considerations, several Republicans have

introduced bills in the House of Representatives that would explicitly forswear any federal aid for state and local pension plans.

Hidden subsidies may be difficult to provide in the current environment. A few years back, it would have been easier to conceive of a federal program of guarantees that would have been set up in a manner that had little or no impact on the federal budget despite constituting a considerable economic subsidy. Fannie Mae and Freddie Mac, for example, were almost universally understood to benefit from implicit federal guarantees of their debt, but the lack of an explicit guarantee allowed that significant subsidy to stay off the federal budget. There may be room from a technical point of view to create a similar program that provides guarantees for state pensions without a significant impact on the federal budget. In fact, providing PBGC or PBGC-like guarantees, with no explicit federal support, might do this fairly directly. However, it is very difficult to conceive of this remaining "hidden" in a political environment that is highly focused today on "bailouts" and "moral hazard" and fears about the ballooning budget deficits. It would take only a short time for the argument to spread that proponents were trying to set up another Fannie Mae or creating another future "bailout" like that for the banks. This is a very powerful argument politically, since Fannie and Freddie may well cost the taxpayers hundreds of billions of dollars in the end and the bank bailouts are hated by the public, even though taxpayers will make a net profit on the investments in banks[8].

Liberals would oppose bankruptcy law changes. The proposed bankruptcy law changes are championed by some conservative Republicans, who generally see them as an important tool that provides leverage against the public employee unions. However, Democrats in Congress are likely to oppose these changes virtually unanimously. This in itself would almost certainly be enough to stop such a change anytime soon, given the power of filibusters in the Senate, even if control of the Senate and the Presidency were to change hands next election. In addition, even some Republican members of Congress are likely to be uneasy with the potentially complex set of actions and reactions that would be set off by such a change. Bankruptcy law is quite difficult to change anyway, since it affects so many different economic interests in potentially cross-cutting ways. In this particular case, investors in municipal bonds are almost universally opposed to the bankruptcy law change. They understand that its proponents are aiming it at the unions and at pension benefits, but the investors believe that it nonetheless would make it easier for a state to choose not to pay all its bills and that bondholders might be paid less than 100 cents on the dollar as a result. After all, it could be somewhat risky politically to take benefits away from teachers and firefighters and other popular groups while paying rich people and banks and insurance companies the full amount promised on their bonds.

New information disclosure might be politically feasible. Disclosure and accounting changes may well be the easiest to do politically. Admittedly, most state and local governments and their public employee unions do not want state and local entities to be forced to provide figures for their pension deficits that are based on a more conservative discount rate, or, in many cases, to provide other additional

---

[8] There may be a net loss on the aggregate TARP program, but the portion invested in banks is set to return a profit.

information about their situations. Anything that implies a higher pension deficit would increase pressure for a reduction in future benefit promises and possibly even for a cutback in previously promised benefits or a commensurate reduction in future salary increases. These groups and their allies are likely to oppose any legislative attempt to force the provision of this information. Some strong federalists are likely to join in, seeing this as an illegitimate extension of federal powers.

However, it is easier to gain a majority for better information than for taking an action that costs taxpayers money. Given the strong views of most economists on this topic, there is some possibility of such information requirements being passed into law or regulation, especially over time. Politically, it could be a way to signal concern and to take action, without spending any taxpayer dollars.

Appendix A: Funding Ratios by State on Two Alternative Bases

	Funding Ratio Stated Basis	**Unfunded Liability** Stated Basis ($ billion)	**Funding Ratio** Treasury Rates	**Unfunded Liability** Treasury Rate ($ billion)
New York	**101**	**-1**	**59**	**133**
Wisconsin	**100**	**0**	**51**	**56**
Washington	**99**	**1**	**50**	**43**
North Carolina	**97**	**2**	**63**	**38**
Delaware	**94**	**0**	**53**	**5**
South Dakota	**92**	**1**	**55**	**5**
Tennessee	**90**	**4**	**53**	**23**
Wyoming	**89**	**1**	**45**	**5**
Nebraska	**88**	**1**	**47**	**6**
Georgia	**87**	**10**	**48**	**57**
Oregon	**86**	**8**	**53**	**38**
Utah	**86**	**3**	**47**	**16**
Florida	**84**	**23**	**52**	**90**
Texas	**84**	**25**	**47**	**142**
California	**81**	**93**	**47**	**370**
Iowa	**81**	**5**	**51**	**17**
North Dakota	**81**	**1**	**43**	**4**
Pennsylvania	**81**	**21**	**39**	**100**
Virginia	**80**	**14**	**46**	**48**
Michigan	**79**	**15**	**38**	**64**
Missouri	**79**	**12**	**44**	**42**
Arizona	**78**	**10**	**34**	**49**
Arkansas	**78**	**5**	**48**	**16**
Minnesota	**77**	**14**	**39**	**55**
New Mexico	**76**	**7**	**40**	**24**
Alabama	**74**	**11**	**35**	**40**
Idaho	**74**	**3**	**52**	**8**
Montana	**74**	**3**	**43**	**7**
Maine	**73**	**4**	**41**	**12**
Vermont	**73**	**1**	**43**	**3**
Nevada	**72**	**9**	**52**	**17**
Colorado	**69**	**17**	**33**	**57**
Hawaii*	**69**	**5**	**34**	**16**
South Carolina	**69**	**13**	**32**	**43**
Massachusetts	**68**	**20**	**38**	**54**
Indiana	**67**	**12**	**39**	**30**
Mississippi	**67**	**10**	**35**	**29**
New Jersey	**66**	**46**	**35**	**124**
Ohio*	**66**	**58**	**41**	**167**
Maryland	**65**	**19**	**40**	**44**
Kansas	**64**	**8**	**34**	**20**
Connecticut	**62**	**16**	**29**	**49**
Alaska	**61**	**6**	**57**	**9**
Louisiana	**60**	**16**	**33**	**36**
Rhode Island	**59**	**5**	**32**	**14**
Kentucky	**58**	**15**	**33**	**42**
New Hampshire	**58**	**4**	**35**	**8**
Oklahoma	**57**	**15**	**34**	**30**
West Virginia	**56**	**6**	**39**	**11**
Illinois	**51**	**62**	**28**	**167**
Cumulative		**656**		**2486**
Median	**75**	**9**	**42**	**37**
Average	**76**		**43**	

Source: Pew Center The Trillion Dollar Gap Grows Wider, Joshua Rauh and Robert Novy-Marx Public

* Pew was able to obtain fiscal year 2009 data for all states except Hawaii and Obhio. For Hawaii, fiscal year 2008 data were used; for Ohio, 2009 data were projected using preliminary valuations.

Appendix B: Pension Deficit in Relation to Size of State Economies on Two Alternative Bases

	Underfunding as a % of Gross State Product (Stated)	**Unfunded Liability** Stated Basis ($ billion)	**Underfunding as a % of Gross State Product** (Treasury)	**Unfunded Liability** Treasury Rate ($ billion)
New York	**0%**	**-1**	**12%**	**133**
Wisconsin	**0%**	**0**	**23%**	**56**
Washington	**0%**	**1**	**13%**	**43**
North Carolina	**1%**	**2**	**9%**	**38**
Delaware	**1%**	**0**	**8%**	**5**
Nebraska	**1%**	**1**	**7%**	**6**
Tennessee	**1%**	**4**	**9%**	**23**
South Dakota	**2%**	**1**	**12%**	**5**
Wyoming	**2%**	**1**	**14%**	**5**
Texas	**2%**	**25**	**12%**	**142**
Georgia	**3%**	**10**	**14%**	**57**
North Dakota	**3%**	**1**	**11%**	**4**
Utah	**3%**	**3**	**15%**	**16**
Florida	**3%**	**23**	**12%**	**90**
Virginia	**3%**	**14**	**12%**	**48**
Iowa	**4%**	**5**	**12%**	**17**
Arizona	**4%**	**10**	**19%**	**49**
Pennsylvania	**4%**	**21**	**18%**	**100**
Michigan	**4%**	**15**	**17%**	**64**
Vermont	**4%**	**1**	**13%**	**3**
Indiana	**5%**	**12**	**12%**	**30**
Oregon	**5%**	**8**	**23%**	**38**
Missouri	**5%**	**12**	**18%**	**42**
Arkansas	**5%**	**5**	**15%**	**16**
California	**5%**	**93**	**20%**	**370**
Massachusetts	**5%**	**20**	**15%**	**54**
Minnesota	**5%**	**14**	**21%**	**55**
Idaho	**6%**	**3**	**15%**	**8**
New Hampshire	**6%**	**4**	**14%**	**8**
Kansas	**6%**	**8**	**16%**	**20**
Alabama	**6%**	**11**	**24%**	**40**
Maryland	**6%**	**19**	**15%**	**44**
Colorado	**7%**	**17**	**23%**	**57**
Connecticut	**7%**	**16**	**22%**	**49**
Nevada	**7%**	**9**	**14%**	**17**
Montana	**7%**	**3**	**20%**	**7**
Maine	**8%**	**4**	**23%**	**12**
Louisiana	**8%**	**16**	**17%**	**36**
Hawaii	**8%**	**5**	**24%**	**16**
South Carolina	**8%**	**13**	**27%**	**43**
New Mexico	**9%**	**7**	**32%**	**24**
New Jersey	**9%**	**46**	**26%**	**124**
Kentucky	**10%**	**15**	**27%**	**42**
Oklahoma	**10%**	**15**	**20%**	**30**
Illinois	**10%**	**62**	**27%**	**167**
Rhode Island	**10%**	**5**	**29%**	**14**
West Virginia	**10%**	**6**	**18%**	**11**
Mississippi	**11%**	**10**	**30%**	**29**
Ohio	**12%**	**58**	**35%**	**167**
Alaska	**13%**	**6**	**20%**	**9**
Median	**5%**	**9**	**17%**	**37**
Average	**5%**		**18%**	

Source: Pew Center The Trillion Dollar Gap Grows Wider, Joshua Rauh and Robert Novy-Marx Public Pension Promises: How Big Are They and What Are They Worth?, October 2010, Journal of Finance

* Pew was able to obtain fiscal year 2009 data for all states except Hawaii and Obhio. For Hawaii, fiscal year 2008 data were used; for Ohio, 2009 data were projected using preliminary valuations.