Why Pre-fund? Why Fully Fund?

Most public entities have a policy of pre-funding their pension plans. The evidence of this is the near-universal existence of pension funds—the accumulation of assets set aside for paying future pensions.

But, a commitment to pre-funding is not the same as a commitment to full funding. There is a big, big difference. And the distinctions are often obscured.

Some jurisdictions are content funding toward a target of 90%. Others pursue policies targeting 100% funding, but with a goal of achieving it years into the future, if ever. (Is this full funding?) And still others pursue policies that include significant elements of risk, e.g., an aggressive asset return assumption combined with extended amortization of gains and losses. These all produce the same results.

Is that a problem? Should immediate full funding of current liabilities be the “norm?” In this article we discuss some of the practical issues that question raises.

FUNDING HAS TO OCCUR—EVENTUALLY

Let’s begin with the premise that, unless there is a default, at some point someone is going to have to pay the promised pensions. Who pays for those pensions?

In a private-sector single-employer plan, unless there is a default, the sponsor pays, either currently (via pre-funding) or at some time in the future. If the sponsor does *not* pre-fund, then (1) the plan’s participants and (2) the sponsor’s current creditors are at some risk (of a future default), as are (3) future investors (the value of the company is reduced by the outstanding obligation). Assuming the financial condition of the sponsor and the plan is well understood by all parties, the current creditors and future investors will build into their calculations of the sponsor’s value and credit-worthiness the fact that, at some point, the pension will have to be paid.

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It is, however, harder for employees to take into account the added risk they bear when the sponsor does not pre-fund, and they generally don’t have the flexibility to build risk calculations into their compensation packages. This could be called the “participants’ dilemma.” And it was that dilemma that led Congress to adopt the minimum funding requirements and corporate pension benefit insurance (via the Pension Benefit Guaranty Corporation) included in ERISA. Over the decades since the adoption of ERISA, the full funding of pensions over a relatively short period of time has become the norm for private sector plans.

LESSONS FOR THE PUBLIC SECTOR

Do any of these principles apply to public sector plans? Yes, but…

First, in public sector plans there is a possibility of default. Notwithstanding slogans like "cities last forever," some cities do, literally, explicitly default: file for bankruptcy and renegotiate their obligations to their creditors and to their pension plan participants. Detroit is the most obvious example. And there are also implicit defaults that happen every year—cities go to their creditors (e.g., plan participants and bond investors) and renegotiate their "deal" based on a threat of default or merely on claims of economic exigency.

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Second, theoretically the effect of the deferral of (full) funding on the credit-worthiness of a jurisdiction should show up in the effective borrowing rate. Put another way, bond investors and creditors, and the capital markets, have mechanisms by which they can reflect the deferral of funding in a public entity.

Third, it may be useful to think of the pool of *current* taxpayers in a public entity as analogous to the *current* stockholders of a private sector entity. And future taxpayers—those who will ultimately have to pay the deferred funding cost—as analogous to the future investors of a private sector entity. Those future taxpayers (like future investors) may "discount the value of the municipality," e.g., through reduced property values, to reflect the deferred funding obligation.

But while the future *investors* in a private sector entity can be expected to be very focused on the effect of a pension plan (and especially any deferred funding) on the private sector entity's value, future taxpayers are much less focused on the effect on a public entity of deferred pension funding. Typically, a taxpayer's decision to live in a jurisdiction depends on other very practical matters, such as where her employer is located. Thus, the population of future taxpayers is for the most part dependent on the decisions of businesses to locate (or not locate) in or near the jurisdiction. In the current environment, that decision is likely to reflect, to some marginal degree, the implications of a deferred pension obligation for the jurisdiction's financial condition, but not with the mathematical precision of the calculations made by future investors in the private sector.

CONCERNS ABOUT LESS-THAN-FULL FUNDING IN THE PUBLIC SECTOR

So: *Yes*, the concerns that have led to today's "full funding" regime in the private sector—participant concerns about benefit security, creditor concerns about a possible default, and future investor concerns about compromised value—also exist in the public sector. *But*, the mechanisms by which those concerns can be brought to bear and affect funding policy are much weaker in the public sector. Thus, it may be possible to defer funding of pensions without causing obvious participant unrest or, in the short term at least, increasing borrowing costs or discouraging employers from staying in or re-locating to the metropolitan area.

REAL-WORLD CONSEQUENCES

Those concerns should not be considered merely hypothetical. They reflect the increased real-world risk to the jurisdiction that deferral of funding presents.

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The cost of the pension benefit earned this year is a current operating expense, part of the municipal worker's current compensation. If it is not fully funded currently, then the municipality is, in effect, using debt (borrowing from the future) to pay that operating expense. Doing this—funding operating expenses with debt—raises serious issues. Because, unlike borrowing associated with, for instance, infrastructure, there is no asset on the other side of the balance sheet to offset the new debt. A city wouldn't be expected to issue debt to pay for this year's fire protection. And thus it generally should not defer funding (borrow from the future) of this year's pension accrual (compensation) for a firefighter. Services performed yesterday for which a pension was not adequately funded don't generally produce an asset for tomorrow.

When a jurisdiction defers the funding of a current pension accrual, there are three possible outcomes:

- **Assuming an increasing economy or tax base** The current cost is shifted into the future, to taxpayers who (theoretically) have more capacity to pay for that pension accrual.
- **Assuming a stable economy or tax base** Current taxpayers book a one-time gain, by shifting this year's pension cost to some future year's taxpayers. But some future year's taxpayers must (because someone must) pay for the pension. Those future taxpayers are faced with the choice of also paying for *their* current year's pension accrual, in which case they are paying twice (for the previously deferred cost and for the cost of the current year's pension accrual), or deferring the current year's cost to some other future year's taxpayers. So, yes, current taxpayers in this circumstance get a gain; everyone else is stuck.
- **Assuming a declining economy or tax base** The current cost is shifted into the future, to taxpayers who have *less* capacity to pay for the cost of current pension accruals. The disastrous consequences of this are obvious.

MOBILITY MAY DEFEAT INVESTMENT

Thus, by not fully funding current pension benefits, public entities are gambling on their economic future.

That may make some sense if the item the public entity is investing in "stays put"—the way infrastructure (e.g., a bridge) stays where you put it. Unfortunately, given population mobility, "investing" in compensation—the pension benefit of a policeman, a firefighter or a teacher—does not necessarily produce infrastructure that stays put. The child the teacher educates may simply leave the jurisdiction, taking everything she has learned with her.

Public jurisdictions routinely compete against each other to attract employers, and the taxpayers they bring with them, to their jurisdictions. And if some of those jurisdictions are burdened with deferred pension costs, while others are not, at the margin the entities that have lower deficits (e.g., due to greater pre-funding) will win those contests.

That is not to say that it may never make sense to, for instance, defer pension funding so that an entity can improve teachers' salaries, attract better teachers and thereby attract more employers and taxpayers. But doing so is not without considerable risk.

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RISK IS RELATED TO SIZE

This risk is greatest for municipalities: it's seemingly easy for a business or taxpayer to simply move over the line and out of the city or county that has the heavy pension-based tax burden. The risk is a little lower for states, simply because they are harder to leave. And it seems (nearly) non-existent at the federal level. Perhaps a few will renounce citizenship simply to avoid paying the cost of pension benefits, but that seems like the exception.

WHY PRE-FUND? WHY FULLY FUND?

For these reasons, we believe that, except in unusual circumstances, fully funding pensions earned currently is the best policy. It provides participants with benefit security. In the long run, it will reduce borrowing costs. And it promotes the buy-in of employers and taxpayers.

For more information contact The Terry Group at 312-574-1500 or info@terrygroup.com, or visit us online at terrygroup.com.

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