Mitchell's Musings 11-2-15: The Ghost of Benefits Past

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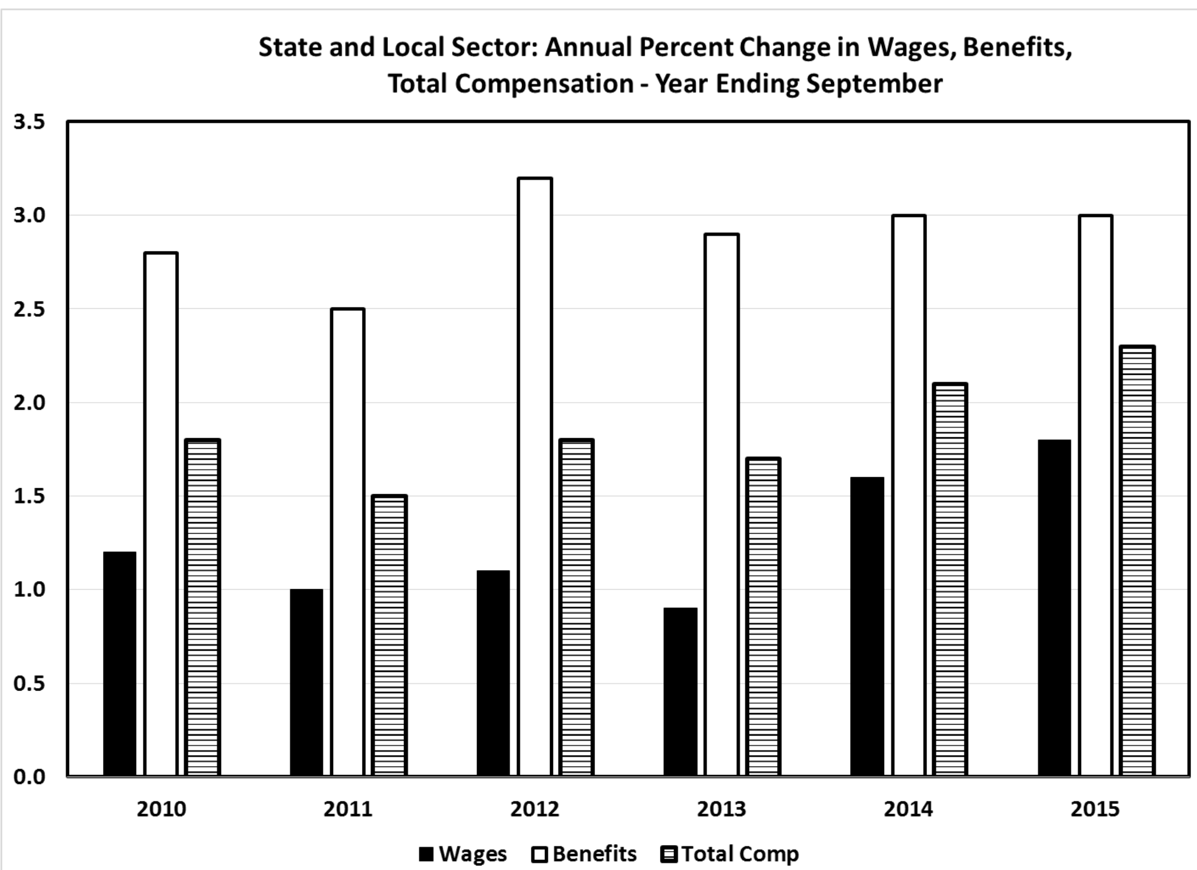
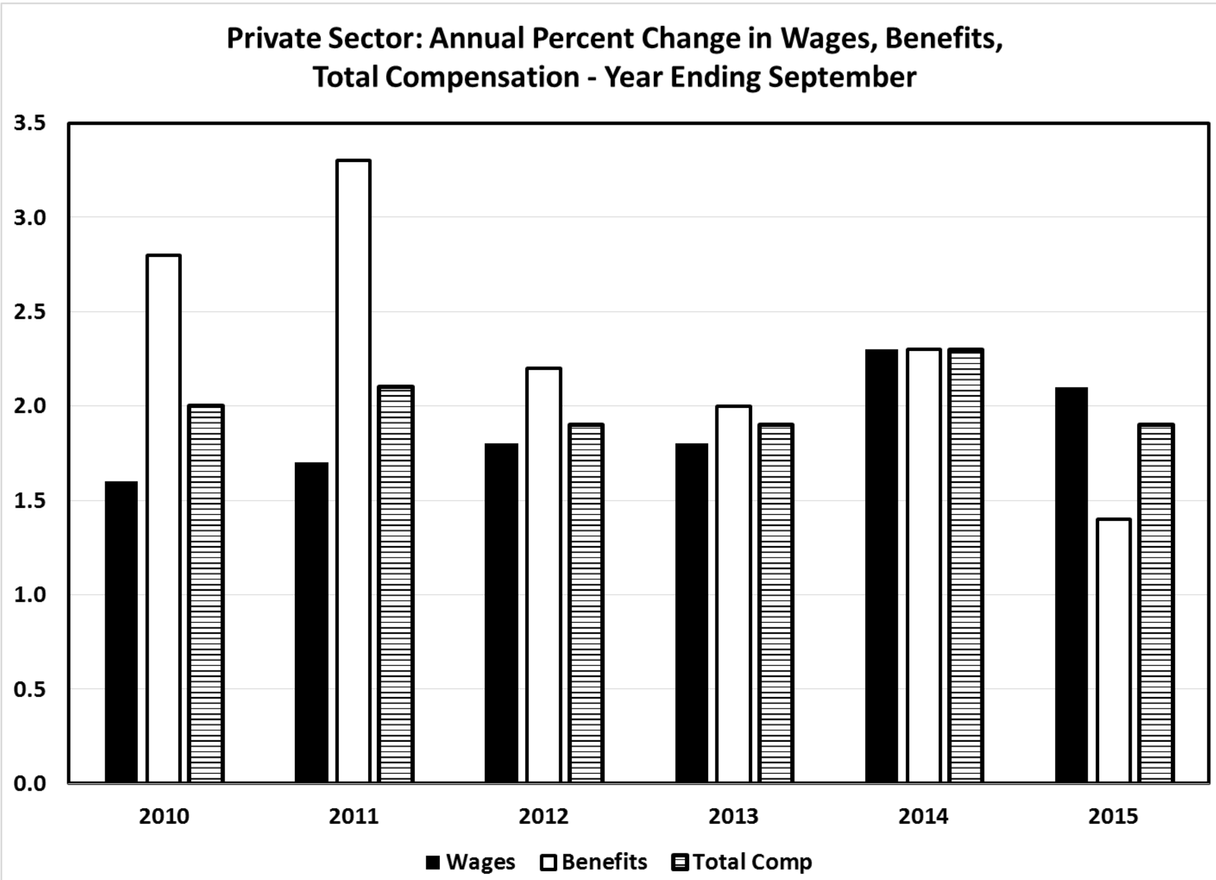
The Great Recession and the accompanying stock market crash substantially worsened the funded status of most defined-benefit (DB) pension plans. And nowadays, you typically find such DB plans in the public sector. Private sector plans of the defined-benefit type in the past were heavily associated with the much-reduced union sector. Generally, such plans were either not offered by private nonunion employers or, more recently, were terminated and replaced by defined-contribution (DC) plans, which are essentially tax-favored savings accounts.

At the bottom of the Great Recession in June 2009, according to the U.S. Bureau of Labor Statistics (BLS), expenditures of private employers for DB-type pensions averaged 41 cents per hour. That average figure included the many employers who had no such plans and thus were paying zero. Private employers paid 53 cents per hour into DC-type plans. In contrast, state and local governments were paying $2.85/hour into DB plans and 31 cents per hour into DC plans. So the difference between the sectors as to plan coverage and cost is striking.

What has happened since the end of the Great Recession in 2009? As the chart below shows, nominal wages rose at a very moderate pace in the state and local government sector through September 2015. On an annual basis, the pace ranged from a little below 1% per annum to a little under 2%. In contrast, the annual nominal increase in state and local benefit costs per hour ranged from 2.5% to a bit over 3%.



The Employment Cost Index on which the chart is based doesn't break down the composition of benefit costs. It's likely, however, that an effort to catch up with the post-Great Recession unfunded liability in DB pensions was a major factor in the gap between wage inflation and benefit inflation in the state and local public sector. It's true that health care costs probably played some role, too. The Affordable Care Act ("Obamacare") took effect during this period and may have added some mandated costs. But in the public sector, health plans tend to be generous and they probably were not much affected. A significant element in Obamacare was expanding coverage which was already wide in the public sector.

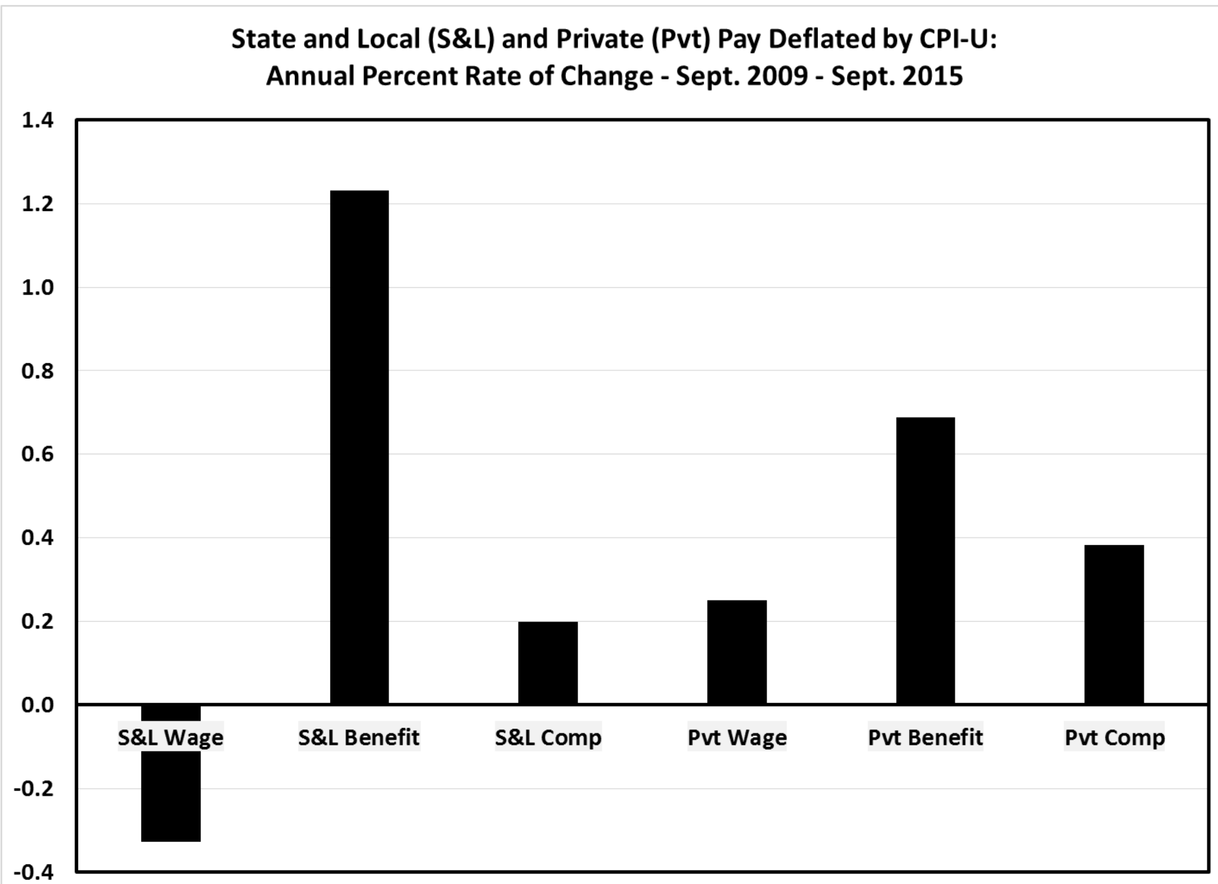


In the private sector, the faster pace of benefit inflation relative to wage inflation is marked only in the first couple of years of the 2010-2015 period. Private DB plans, like their public counterparts, experienced an increase in unfunded liability due to the Great Recession. But since DB pensions play a minor role in costs in the private sector, it is more likely that health expenses were the major factor to the extent that benefit inflation exceeded wage inflation.[1]

[1]BLS has a quarterly data series on Employer Costs for Employee Compensation. Unlike the quarterly Employment Cost Index on which the charts are based, the series does not have fixed weights and so changes in occupation and industry affect the time trends. Private employers spent $1.99/hour on health insurance in June 2009 which rose to $2.42/hour in June 2015 (the latest date for available data). The nominal increase was an annualized rate of 3.3%. (Figures include zeros for employers and employees without health insurance.) State and local government employers spent $4.34/hour on health insurance in the earlier period and $5.15/hour in the later period (a lesser annualized rate of increase of 2.9%).

When a given level (quality and quantity) of benefits simply costs more – pure inflation – workers get no benefit from the added expenditure. So if a DB pension plan becomes more underfunded and payments to it are increased, there is no immediate benefit to workers. They have the same pension promise as before, but there are more costs (to someone) to maintain that promise. Similarly, if the costs of health care procedures rise and premiums are raised as a result, workers have the same benefit as before, but someone is paying more for it.

As noted, with the coming of Obamacare, it is more likely that private-sector workers received some actual benefit improvement than did public-sector workers. Private workers were more likely to become covered by insurance and to experience improved coverage. However, for state and local government workers, the impact of DB pension underfunding is more likely to be the cause of benefit cost inflation. There was more cost - but no improvement in quality or quantity of the pension promise.



When we look at wage changes in real terms (using the Consumer Price Index – CPI-U) for deflation), we find that in the post-Great Recession period, real wages for state and local public workers actually *declined* by about 0.3%/annum. (See the chart above.) Benefits in real cost terms rose by over 1.2%/annum – but, as noted, it is likely that the increase simply reflected catch-up funding for underfunded plans, not an improvement in promised retirement benefits. Private-sector workers since the Great Recession ended experienced a wage *gain* of +0.3%/annum. And some of their benefit gain of around 0.7%/annum may have reflected actual benefit improvements.

In short, the data available suggest that the cost of added catch-up funding for underfunded public pensions fell at least partially on state and local government workers in the form of lower real take-home pay, even apart from any explicit increase in employee contributions. Today's public workers are helping to fund a pension payment that someone neglected to make in the past. And that fact is something that is often neglected today in the debates over public pensions.