How to Save Public Pensions, No Federal Bailout Needed.

It isn't unprecedented for the feds to spur local pension reform. Kennedy and Reagan both did.

The pensions of states and local governments are, collectively, trillions of dollars in the hole. This debt is crippling budgets and will dump an enormous burden on future generations. Yet state and local politicians have proven that they cannot, or will not, solve the problem. The federal government ought to step in. But how?

Instead of bailing out these pensions, Congress should pass a law allowing states and local governments to reduce promised benefits—something that is now illegal under some states' statutes or constitutions. Congress should stipulate that pension plans must be in very bad shape to qualify for relief, and the politicians in charge of them would have to voluntarily seek it. Most important, pensions should be required to uphold their original intent: to keep retirees who can no longer support themselves out of poverty.

Even with those restrictions, significant savings could be made. Many pensions allow retirement at age 55; states and local governments could mandate that benefits cannot be drawn until age 65. Payments could be capped at 150% of the median income in the local jurisdiction. Automatic cost-o--living increases that now exceed expected inflation could instead be tied to increases in the median income.

Troubled plans should qualify for relief only if their funding ratio falls below 50% and has failed to improve over the past five years. These are the plans that are in fiscal quicksand and cannot be saved without significant changes.

Local governments must also be required to terminate their defined-benefit plans. These should be replaced with defined-contribution plans, like 401(k)s or 403(b)s, or active employees could be enrolled in Social Security. Responsible officials are already taking this step: The board of the Tennessee Valley Authority voted in May to switch to a 401(k)-type plan and lower the cap on cost-of-living adjustments.

Once these steps are taken, the local government should be required to fully fund the remaining pension liability with a tax increase. That should be the deal: To receive the relief of reducing promised benefits, they must agree to solve the pension problem once and for all.

What would this look like in practice? Let's say that a retired firefighter in a troubled pension plan is set to receive $70,000 annually. If that is below 150% of the median income in his local jurisdiction, under federal relief his annual benefits would never be subject to the cap, since they would rise as the local median income increases.

What about a retired cop who became a city councilman and later a county supervisor—an extreme, but not unheard of, case? The cop would not be able to collect three pensions and would have his benefit reduced to meet the cap. Both the firefighter and the politician would have to wait until turning 65 to receive benefits.

No one wants to see his benefits reduced. Yet keep in mind that a retiree who receives a $75,000 pension for 30 years, with 3% compounded cost-of-living adjustments, gets total payments of more than $3.4 million. This has become common in cities like Chicago.

I am not the first person to suggest federal intervention. Rep. Devin Nunes (R., Calif.) proposed withholding federal aid to government entities that don't accurately report pension funding. That would be a step forward but would not solve the problem of underfunding.

Diana Furchtgott-Roth of the Manhattan Institute has proposed a law that would allow local governments to seek relief from pension debt in bankruptcy court. But this leaves too much discretion to judges and could lead to wildly different outcomes. Plus, such open-ended relief would be fiercely fought by public-employee unions every step of the way.

Federal intervention is not unprecedented. The Windfall Elimination Provision of the Social Security Act, an amendment that was passed in 1983, allows the federal government to reduce Social Security payments when recipients also receive pensions from public employment. This has curbed double-dipping and protected the Treasury.

Nor should a new plan for federal relief be seen as a purely partisan issue. In 1961 President John F. Kennedy established the Committee on Corporate Pension funds. This eventually led to the Employee Retirement Income Security Act of 1974, which outlawed abuses and forced private firms to put required money into their pension plans each year.

The plan outlined here would create a consistent and concrete path toward making pensions manageable for taxpayers. At the same time, it would protect retirement income for those unable to support themselves. The next president and Congress should take action to allow local governments to address this monumental problem—which gets worse by the day.

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