BROOKINGS

Up Front

How bad is the state and local pension crisis really?

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Editor's Note:

This paper was prepared for the 2019 Municipal Finance Conference on July 15 & 16, 2019. The conference is a collaboration of the Brookings Institution's Hutchins Center on Fiscal and Monetary Policy, the Brandeis International Business School's Rosenberg Institute of Public Finance, Washington University in St. Louis's Olin Business School, and the University of Chicago's Harris Institute of Public Policy. It aims to bring together academics, practitioners, issuers, and regulators to discuss recent research on municipal capital markets and state and local fiscal issues.

State and local government pension plans hold nearly $4 trillion in assets and provide retirement income to over 10 million Americans. For most of these plans, the value of liabilities for future benefit payments exceed the value of plan assets. According to many journalists, academics, and policymakers, this failure to fully prefund state and local pensions constitutes a crisis. In a paper presented at the 2019 Municipal Finance Conference at Brookings, Jamie Lenney of the Bank of England, Byron Lutz of the Federal Reserve Board, and Louise Sheiner of Brookings provide an alternative view. Instead of focusing on a full prefunding benchmark, they focus on the sustainability of pension plans—whether plans will run out of assets and need to borrow money or be bailed out to meet benefit obligations.

Focusing on sustainability, Lenney, Lutz, and Sheiner argue, is appropriate for assessing the effect of pensions on state and local finances for several reasons. First, it provides a clear answer to the pressing question of whether public pensions are likely to spark a fiscal crisis. Second, it is consistent with history; in aggregate, these plans have always operated far short of full prefunding. Finally, getting to full prefunding is not necessarily welfare enhancing.

The authors use information in pension actuarial reports and state government comprehensive annual financial reports to project the benefit payments to current and future retirees for a sample of 40 pension systems. They find that benefit payments, as a share of the U.S. economy, are currently at their peak and will remain there for roughly the next two decades. Thereafter, reforms instituted by many plans to lower benefits will gradually cause a significant decline in the size of pension payments relative to GDP. This suggests that the cashflow pressure plans are currently experiencing will eventually recede.

Aggregating across the 40 pension systems, the authors find that under 3.5 percent and 1.5 percent real asset returns, pension systems will run out of assets in roughly 50 years and 30 years, respectively, and are therefore not currently fiscally stable. That said, plans can stabilize assets and debt as a share of the economy with only moderate increases in contributions, equal to 5 percent and 12 percent, respectively, of their payrolls. In addition, under low 1.5 percent asset returns, the increase in contributions required to stabilize the pension system is similar whether plans act now or in 10 or 20 years. In contrast, the increases required to achieve full prefunding are substantially larger and would likely spark a fiscal crisis. Finally, there is significant heterogeneity across plans, and some plans require substantial contribution increases to achieve fiscal stability across a range of asset return assumptions.

In short, Lenney, Lutz, and Sheiner conclude that, on the whole, state and local pension systems in the U.S. are not facing in an imminent crisis.

Read the paper here»