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How Bad Is the State and Local Pension Crisis Really?

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.

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The Brookings Institute

by Finn Schuele and Louise Sheiner

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