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New Issue Brief: Time to Fix Underfunding of Public-Sector Pensions - Manhattan Institute

The current high-interest rate environment presents a unique opportunity to correct accounting practices and to set public-sector pensions on a more sustainable path

NEW YORK, NY — Public-sector pensions are facing a significant underfunding crisis that has only worsened over the past 25 years despite periods of high-asset returns. This growing burden threatens the financial stability of municipal and state finances, potentially leading to higher taxes or severe cuts to retirees' benefits and essential services if not addressed promptly. In a new Manhattan Institute issue brief, senior fellow Allison Schrager argues the current high-interest rate environment presents a unique opportunity to set public-sector pensions on a more sustainable path.

Improper pension accounting standards set by the Governmental Accounting Standards Board (GASB) are at fault for masking the true extent of underfunding. The GASB allows states and municipalities to underprice risk and the cost of their obligations—a practice that is at odds with basic finance and different from how pension liabilities are measured in the private sector. Current accounting effectively incentivizes riskier investments and overly optimistic return assumptions.

State and local pension plans use accounting standards suggested by GASB to measure their funding status in their Annual Comprehensive Financial Report (ACFR). While the ACFR does not necessarily have any direct impact on the contributions that states and cities pay to fund their pensions, it enables further underfunding because it suggests that risk is costless and that providing pension benefits is cheaper than it is.

The gap between expected returns and interest rates is narrower in the current high-rate environment, making it politically and economically feasible to adopt more defensible standards. States and municipalities should use the opportunity to adopt better and more uniform standards for how liabilities are measured and for how contributions are calculated and paid. By requiring sponsors to account for risk and the cost of guarantees, the focus would shift from returns to risk management, promoting long-term fiscal sustainability. Such accounting would ensure that regardless of rising or falling rates in the future, pensions would be properly funded.

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