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What Crisis? The Case for Not Panicking Over Pension Debt.

New research released this week shows that even pension plans with big unfunded liabilities are likely to survive in the long term.

Over the past decade, public retirement costs have spiked while governments' unfunded liabilities –now totaling more than $1.2 trillion — have continued to grow.

But according to research that debuted this week, lawmakers shouldn't worry too much about accumulating pension debt. "There's an assumption that fully funding pensions is the right thing to do," said the Brookings Institution's Louise Sheiner at the paper's presentation. "Most of the work in this area has been about calculating how unfunded these plans are [and] that's led to a lot of concern that these plans are in a huge crisis."

Sheiner, along with co-authors Byron F. Lutz of the Federal Reserve Board and Jamie Lenney of the Bank of England, say that's not the case. They argue that pension debt is stable as long as its size relative to the economy doesn't increase. "When you approach the pension situation from a public finance [and sustainability] angle," Sheiner said, "there's less of a crisis than is typically portrayed."

The paper, which was presented at the Brookings Institution's annual municipal finance conference in Washington, D.C., finds that pension benefit payments as a share of GDP are currently at their peak level and will remain there for the next two decades. That's because the 2008 market crash came at a time when pension plans were starting to see baby boomers retire, meaning they dropped in value just when payments to retirees were starting to increase.

By 2040, however, the reforms instituted by many plans following the financial crisis will gradually cause benefit cash flows to decline significantly. Since those changes were to current employees' plans, governments won't see the full effect of those savings until those workers retire.

All of this means that, according to the research, the worst of it is over for most pension plans. For the next 40 or so years, the ratio of pension debt as a share of the economy is expected to remain the same, as long as the plans achieve moderate investment returns and governments continue to make consistent payments equal to or slightly higher than they are now.

Those, however, are two big conditions. Consistent payment schedules that last more than a few election cycles can be difficult for politicians.

Take Illinois. In 1994, it set a 50-year payment schedule that would fund the plan at 90 percent. For the first decade of the schedule, the payments were low. They've since started ramping up. As costs have increased, lawmakers have consistently found ways to avoid making them, meaning that the expected contributions are getting even bigger and bigger. Illinois now has one of the highest state contribution rates as a share of payroll, around 50 percent.

Sheiner said there are some plans, such as Puerto Rico's, that are essentially out of money and probably in need of a bailout. But most plans could achieve their definition of stability by maintaining or slightly increasing their current contribution rate as a percentage of payroll. (The U.S. average is 17.4 of payroll.)

The main concern, she adds, is with all this pressure to be fully funded, what are states giving up? And is that even necessary? “You do hear a lot of stories about people wanting to do things that are incredibly valuable, like getting lead out of water and investing more in education. These have huge rates of return that affect people’s health, inequality, basically everything that’s really important,” she said. “And they can’t do it because they have to fully fund their pension.”

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BY LIZ FARMER | JULY 19, 2019 AT 4:00 AM