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The State Pension Crisis Goes Beyond the Big Blue States.

Politicians and fund administrators everywhere wasted the reform potential of an 11-year bull market.

Legislators from Illinois and New Jersey provoked an outcry in April when they asked Washington to bail out their failing pension systems. Senate Majority Leader Mitch McConnell offered instead to let states file for bankruptcy. His message: Don't expect aid for problems that have little to do with fighting the novel coronavirus and the economic slowdown accompanying it.

The crisis in state pension systems is a result of decades of fiscal mismanagement. The problem, however, goes well beyond deeply indebted Illinois and New Jersey. Many state and municipal retirement funds have been on an unrelenting downward trajectory for 20 years, failing to gain ground even during the 11-year bull market that followed the 2007-09 recession. Now, with the economy in tatters because of the coronavirus, more government pension systems are close to a crisis, and taxpayers are running out of time to demand a solution.

The figures are startling. At the end of the 1990s, most pension systems were fully funded, with no debt. But the steep market declines of 2000 and 2001 drove funding levels down to 89% by 2003, and debt soared to $233 billion, according to Pew Research. Though pension administrators assured taxpayers the funds would rebound, the plunge in financial markets in 2008 sent systems reeling again. By 2010 state funds were on average only 75% funded, and unfunded liabilities had tripled to $750 billion. Years of subsequent market gains haven't reversed the trend. By 2018 state pension debt had reached $1.2 trillion, and the latest market downturn has almost certainly sent it soaring again.

This fiscal nightmare stems in part from politicians' habit of increasing employee benefits while markets are booming, thereby squandering fund surpluses. California's Legislature gave workers rich new benefits in 2000, allowing some 200,000 employees to retire with full pensions at 55 and granting Highway Patrol officers pensions equal to 90% of their final salaries. Although executives of the California Public Employees' Retirement System, which was 120% funded at the time, assured legislators they could pay those benefits without additional contributions from governments, subsequent market downturns have forced the state and local governments to increase their annual contributions to $15 billion last year, up from $362 million in 2000. Calpers' funding level, meanwhile, shrank to 70% last year—and is even lower now.

Politicians have consistently neglected to contribute to these systems even during good budgetary times, preferring to fund more popular programs. While the economy was expanding from 2015-17, 27 states failed to put enough money into pensions systems to reduce their debt, according to a Pew survey.

Meanwhile, elected officials and pension administrators have endorsed overly optimistic economic assumptions that made their systems look affordable. In 2007, for instance, most state funds projected an annual return of 8% or more on their investments. Under intense criticism, many have now pared down projected returns to 7.25%, but doing so has added billions of dollars of debt.

Here's a reality check: Over the past decade, state pension systems averaged only 6.8% actual returns, according to Wilshire.

Even before the most recent market drop, a striking number of funds were already at or dangerously close to crisis levels. A 2019 study by Milliman identified a dozen state and big municipal plans with less than half the funding needed to fulfill their obligations, and another 14 with funding below 60%. That included the Pennsylvania school retirement system (54%), South Carolina's retirement system (54.1%), the Massachusetts teachers' system (54.8%), and the state plans in Colorado (58.8%) and Missouri (59%).

This is worrisome because, as Calpers officials admitted after a 2015 review of their operations, once a pension system slips below half-funded, it may be impossible to save it no matter how much taxpayers contribute. The money that should be earning market returns simply isn't there. That's why it's urgent for taxpayers to demand reforms now.

One alternative, proposed in 2015 by a bipartisan New Jersey study commission, would close the state's deeply indebted defined-contribution plan and migrate workers into a cash-balance program that provides a modest annuity roughly equivalent to Social Security, supplemented by a 401(k)-style savings plan. The Garden State's powerful unions blocked that plan, but other states might consider adopting it.

Another option, enacted by Utah, allows workers to join their defined-benefit plan only if they agree to pay any extraordinary costs incurred from market downturns. Otherwise, workers enroll in a 401(k)-style contribution plan that limits taxpayer liability.

For some pension funds, stronger medicine is necessary. The New Jersey teachers' retirement plan is 26.5% funded, according to Milliman, and pays nearly $1.7 billion more in pensions every year than it receives in contributions, Although Mr. McConnell backed off his state-bankruptcy plan, in 2016 the Manhattan Institute proposed model legislation that would allow states to place their pension systems alone in bankruptcy to reorganize.

There are other options for reform, too. But they all require something that's been missing: political will. Something else that's needed, time, is running out.

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