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POLICY BRIEF
COVID-19 RESPONSE

Pandemic Recovery and State and Local Pension Reform

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In 2019, few could have predicted that state and local pension funds would be faced with a pandemic that would slash state and local tax revenues and harm investment returns. Nevertheless, fund managers should have spent the past decade preparing for an inevitable market downturn. Instead, just as when the 2008 financial crisis hit, policymakers have spent the previous decade valuing their pension liabilities and assets as if investments always go up. This policy brief explores the deep-seated problems in US state and local pension finance, including underfunding, poor investment choices, and potential avenues for reform.

PUBLIC-SECTOR INCENTIVES AND PENSION UNDERFUNDING

State and local elected officials have insufficient incentives to adequately fund the pension systems they're responsible for. Constituents feel the effects of pension fund insolvency over long time horizons when insufficient resources in pension funds ultimately lead to higher taxes or less government funding available to spend on other priorities, such as education and transportation. By contrast, elected officials commonly focus on short time horizons congruent with reelection campaigns. As a result, politicians tend to favor policies that allow them to cut taxes in the short term, increase spending on projects that will be delivered in the short term, or both.

These incentives mean that politicians are unlikely to responsibly fund long-term liabilities. Pension fund contributions and infrastructure maintenance are less appealing than cutting taxes or increasing spending on projects that will immediately benefit the general public or a vested interest group. The incentives also mean that politicians tend to prefer debt financing, which is paid for with higher future taxes or lower future spending on other government services. Economists call the practice of deferring spending by skimping on long-term expenses *fiscal illusion* because these practices appear to reduce the cost of government programs to current voters.[1]

Pension fund accounting requirements present opportunities for politicians to underfund these long-term liabilities in favor of short-term budget priorities. The Government Accounting Standards Board (GASB) sets the requirements for how much states and localities must contribute to their pension funds annually.[2] But even under GASB's standards, states and localities wouldn't contribute as much to their pension funds as many economists recommend or as much as many other countries require of their pension systems.

In 2014, state and local pensions began valuing pension assets and liabilities according to new GASB guidance. GASB 67 and GASB 68 replaced GASB 25 and GASB 27, which were criticized because plans following them could obscure the full value of their assets and liabilities by discounting guaranteed pension liabilities based on uncertain and volatile returns on assets. Under the new guidelines, plans may measure pension liabilities based on a *blended discount rate*. This approach involves valuing the funded portion of plan benefits based on the expected return on, typically, a mix of higher-risk equities and alternatives, while valuing the unfunded portion of plan benefits based on the lower-risk return on tax-exempt bonds. The expected result of following the new guidance was that poorly funded plans would report higher unfunded liabilities and weaker funding ratios, as more of those plans would be valued based on lower-returning bonds. However, in practice, plans are able to avoid reporting large liabilities by assuming a very long time horizon before the time they run out of assets and applying the higher-risk, higher-return discount rate when valuing a greater portion of their liabilities. For example, Sheila Weinberg and Norcross find that despite poor funding ratios, Illinois based its 2014 pension valuation on the assumption that the plan would not run out of assets until 2065,[3] enabling actuaries to apply the higher rate of return to the entire plan. Thus, the state suppressed the full extent of its plan's unfunded liabilities and reinforced the idea that taking on investment risk is an appropriate strategy for funding guaranteed-to-be-paid pension benefits.

In previous research, Norcross has called this intersection of inadequate fiscal standards and poor enforcement "fiscal evasion."[4] Policymakers have engaged in fiscal evasion with their pension funds by, for example, skipping required payments to their funds, valuing pension liabilities on the basis of unrealistic assumptions about the returns that pension investments will make, and increasing retiree benefits without also increasing pension fund contributions. Voters are rationally ignorant about the details of public-sector pension plans and have little reason to invest the time that would be needed to follow the details of their states' and localities' plans. Therefore, elected officials have little reason to fear repercussion for allowing their plans' funded ratios to decline during their terms.[5]

Pension scholar Anthony Randazzo describes a three-part problem with state and local pension management under current US institutions:

1. Voters do not closely follow pension investment practices, allowing elected officials to avoid consequences for poor fund management at the ballot box;

2. elected officials choose to spend taxpayer resources on projects with visible short-term benefits rather than on long-term obligations; and
3. public-sector unions have focused on increasing compensation, including retirement benefits, rather than requiring members' benefits to be adequately funded.[6]

Tinkering with pension rules has proven not to improve pension funding outcomes. Ongoing shortfalls in public-sector pension funding ratios call for a broader rethinking of public-sector employee retirement benefits.

PUBLIC-SECTOR INCENTIVES AND PENSION FUND INVESTING

Compounding the problem of insufficient contributions to pensions, some pension fund managers and policymakers also invest in assets that advance their political objectives rather than assets that meet their fiduciary duty of achieving an appropriate mix of risk and expected returns. For example, Alabama policymakers have established a practice of investing 10 percent of the state's pension funds in economic development in the state. These investments include Robert Trent Jones Golf Trail, Raycom Media, Walmart, and Community Newspaper Holdings.[7]

Selecting investments with a goal of in-state job creation may result in some new opportunities for state residents, but this comes at the cost of appropriate investment decisions for the assets public employees rely on. It also increases the risk that tax increases or service cuts that affect all of a state's residents will be required in the future, should those investments fail. Furthermore, conducting economic development using pension funds rather than general funds is an opaque process that makes oversight and accountability difficult. Empirical evidence indicates that including more politicians on pension boards is associated with worse investment performance.[8]

In some cases, pension fund investing goes beyond just preferring in-state firms and becomes full-blown corruption. For example, New York's pension fund has seen multiple scandals involving fund managers investing in specific firms or with specific brokerages for personal gain.[9] In general, states with more corrupt governance experience both riskier allocation and lower returns for their pension funds.[10]

Blatant corruption in pension management is not the norm, but it is the norm for pension managers to advance their own interests by charging high fees for funds invested in increasingly exotic mixtures of alternative investments. A 2018 study by the Pennsylvania Public Penson Management and Asset Investment Review Commission finds that actively managed investments in the state's two major plans underperform passively managed index funds.[11] The next section provides a model for public employee retirement benefits that eliminate policymakers' conflicts of interest in selecting pension fund investments.

STATE AND LOCAL PENSION REFORM

The federal government has a role to play in helping states and localities shore up their budgets in the short term as their tax revenues have taken a huge hit from coronavirus closures. However, if the Great Recession provides a model for what to expect for coronavirus-exacerbated pension problems, real insolvency challenges are a few years away. When the stock market bottomed out in 2008, municipal bankruptcies and pension cuts followed in the next five years.

State and local policymakers have proven largely unable to make required contributions to pension funds and invest these funds appropriately. These problems will not be solved with federal aid to temporarily paper over insolvency. Rather, retirement funding for state and local public-sector workers requires serious reform.

Federal government workers' retirement benefits provide a potential model. Federal workers receive their retirement income from three sources: Social Security, the Thrift Savings Plan, and the Federal Employees Retirement System (FERS), a small defined benefit pension. FERS provides a guaranteed annuity payment to retirees based on their salary from the three highest-earning years of employment, the number of years worked, and a multiplier. For the bulk of their retirement income, employees rely on the Thrift Savings Plan, a defined contribution plan that both employees and their agencies contribute to. Plan beneficiaries can choose between 10 investment options. Like the federal government, 11 states (Georgia, Indiana, Michigan, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, Utah, Virginia, and Washington) offer a hybrid defined benefit–defined contribution plan to employees.[12]

The prevalence of defined benefit pension plans in the private sector peaked in about 1980, when 38 percent of workers had them.[13] While private-sector pension funds don't suffer from the same problems of political opportunism that public-sector plans do, they've nonetheless faced funding challenges. A number of multiemployer plans that cover unionized workers in the private sector are projected to run out of assets within the next decade.[14] Owing to the growing expense and financial risks of defined benefit plans to employers, today only about 13 percent of private-sector workers are members of a defined benefit pension plan.[15]

Moving public-sector employees to a defined contribution retirement model addresses the incentive problems that lead policymakers to make problematic choices on both the funding and investment sides of defined contribution plans. Furthermore, transitioning public-sector compensation practices to be more like those of the private sector puts workers in a better position to compare labor market opportunities across both sectors.

Supporters of defined benefit pension systems criticize defined contribution programs for transferring risk to retirees and providing inadequate resources for retirement. To answer the first concern, when pension funds reach crisis levels of underfunding, the burden may be distributed to employees as well as current retirees. For example, when Central Falls, RI, went through bankruptcy in 2012, its public employees emerged with severe cuts to their expected benefits.[16]

To answer the second concern, transitioning to a defined contribution system does not preclude employer contributions to individual accounts to make retirement benefit programs more generous. Rather than necessarily affecting the total benefit amount, transitioning from a defined benefit to a defined contribution pension plan is a move toward a system that avoids the widespread problems that arise when US elected officials are responsible for managing pension fund contributions and investments.

CONCLUSION

Rather than internalize the lessons of the Great Recession and shift portfolios away from high-risk investments, in the past decade, public-sector plans have doubled down and continued to invest more heavily in alternatives in the hope of capturing high returns. Actuarial guidance that allows plans to value liabilities based on the expected return on plan investments embeds an incentive to chase short-term gains and distribute the losses over future taxpayers.

Given the difficulty and reluctance of policymakers to adopt actuarial reforms that present a full picture of plan liabilities, the best course of action is to offer public-sector workers the choice to manage their own retirement contributions and earnings in defined contribution plan. Additionally, policymakers should ensure that existing defined benefit plans are adequately funded, transition investment portfolios away from excessive risk-taking, and adopt an age-based strategy that shifts toward lower-risk investments as employees approach retirement. The practice of embracing increasing investment risk and distributing the losses over future generations runs contrary to good financial management of plans for employees and fiscal responsibility to citizens.

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NOTES

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