



Retirement News Highlights

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Public Pensions and the COVID-19 Fiscal Dilemma

Despite federal scaremongering about state and local pensions, the problem for now isn't their balance sheets. It's the budget vise that is likely to tempt some public employers to cut funding corners.

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We've just passed an annual day of reckoning in public finance: Most states and many local governments close their books for the fiscal year on June 30, and public pension funds typically report their quarterly portfolio balances shortly thereafter. With the Senate still dithering over federal stimulus aid to state and local governments, after its majority leader suggested that state bankruptcies would be a better solution and that it's all the fault of public pensions, it's time to reality-check the pension scoreboards.

The COVID-19 pandemic has crushed the world economy, yet global stock markets have recovered much of their March sell-off. For pension funds, stock portfolios are trading close to the levels of 12 months ago. In their actuarial calculations, most public pension plans use a rolling average of three or five years for investment returns, and my expectation is that most plans will meet those "smoothed" actuarial assumptions even if returns in the last 12 months were flat. Average funding ratios of public pension funds have stabilized since 2016, while many systems have prudently reduced their actuarial return assumptions, which would otherwise depress those ratios had investments disappointed.

Longer-term, however, public pension funds will still have to confront head-on the reality that in the coming decade or two their diversified portfolio investments seem highly unlikely to produce real rates of return (net after inflation) that meet their assumptions. Bond yields remain suppressed, so their market prices are likely to decline over time. There is clearly a risk that inflation will outrun bond returns over the next two decades, especially if mounting federal deficits and debt propel interest rates higher. Stock markets will face a long-term net-profits markdown if and whenever corporate tax rates are increased by a future Congress seeking to balance federal budgets. Heavier debt loads and the global superabundance of investment capital chasing available economic growth will overhang common stock returns.

All of this need not foreshadow a market crash, but it does suggest a multi-decade shortfall relative to expectations for investment returns. The bottom line for public pensions: Employers and employees will likely face higher payroll contribution rates in years ahead, but the pandemic recession itself is only modestly amplifying that trend.

What the recession is provoking, however, is a near-term issue of whether public employers will yield to a temptation to put off actuarially required contributions to their pension funds. I've written previously about the magnitude of sales- and income-tax revenue shortfalls and how federal fiscal aid should be metered out. Unless Congress breaks its logjam and promptly approves hundreds of billions in aid to states and localities, employer contributions from shrinking operating budgets will be the dominant pension issue this summer.

Many states and localities are depleting their rainy-day funds. Layoffs are underway, and more will follow. If nothing is done, public-sector pink slips will surge to many millions by November. If Congress fails to backstop the states and localities, there will be scattered but intense pressure on budget officers, elected executives and legislative bodies to postpone pension payments. Employee unions and social-services advocates will lobby hard for budgeting authorities to protect their interest groups by taking what is known as "pension-contribution holidays." To them, the trade-off is simple: Rather than imposing pain on their constituencies now, kick the can and send the bill to the next generation, despite the inevitable cost of over \$1.50 in today's money for every dollar skipped this year.

Pension-contribution holidays are indisputably one of the worst mistakes made in the past by public employers whose pension funds are now among the most deeply underfunded. Failure to pay the actuarially required contribution when due is a financial maneuver that has almost invariably backfired. Some states outlaw the practice; industry experts strongly discourage it, even in a recession.

Skipping a payment to the pension fund is not much different from missing payments due on municipal bonds — except that the latter immediately gets headlines and worsens the employer's bond rating along with future access to credit markets. However, pension-contribution holidays now must appear in the employer's comprehensive financial reports and may require formal "continuing disclosure" under Securities and Exchange Commission rules that now apply to states and municipalities. No longer can contribution holidays be swept under the rug as a dirty little secret.

The Government Finance Officers Association has prepared insightful "Fiscal First Aid" guidance, which should be studied carefully by public officials who face this dilemma. The GFOA recommendation on pension-contribution holidays is concise: It discourages them as inadvisable, along with gimmicky early-retirement incentives that shift hidden costs to pension funds; these shortcuts simply boomerang later at taxpayer expense.

Pension-contribution holidays are like opioids. They provide short-term pain relief, but they mask the underlying disorder. Their promoters too often are self-interested and prey on political weaknesses. They are addictive, and their long-term consequences can be crippling.

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