A Call for Leadership

Persistent State and Local Public Pension Crises Across the United States
State and local pension systems across the country are facing a funding—and leadership—crisis, one that is unlikely to permanently improve without reforms. As of 2020, funding for such pensions was facing a shortfall of at least $1.5 trillion. And yet, this is not a single crisis—rather, there are many individual crises affecting pension systems across the country.

Some state and local public pension crises are significant. In Stockton, California, an attempt to address underfunding with pension obligation bonds contributed to the city ultimately declaring bankruptcy. In Chicago, which faces a pension liability in 2022 of over $34 billion, more than 80 percent of property taxes go toward employee pensions. Fortunately, most state and local pension systems are not in such dire straits.

Nevertheless, from the mid-2000s to 2020, there was a marked increase in public pension plans moving from safer assets, such as fixed income assets, toward riskier assets. Research indicates that funds may pursue this type of investment approach even more during periods of poor market performance.

And the fallout of such decisions affects more than 27 million current and past state and municipal workers across the United States. These employees make up the nation’s teachers, law enforcement and other first responders, municipal and state service providers, and more, many of whom may be at risk of cuts to their retirement benefits, jeopardizing their retirement security. And pension concerns not just affect these workers’ retirement but also pose challenges to the recruitment and retention of employees who are critical to state and local public services.

Furthermore, taxpayers will eventually be hit with big bills to bail out struggling pension systems—such as the $36 billion in federal funds provided to the Teamsters Union’s Central States Pension Fund in 2022—or face cuts to services when pension funding costs crowd out providing other public services.

“That’s the kind of discussion with push and pull with unions. They were looking out for employees. But at the end of the day, could I afford it? I could go along but might need to cut back on supplies, services, and other things in the budget.”

—Policymaker
Why Are Public Pensions in Such Crisis?

Although recent news stories have been drawing attention to the crises affecting state and local pension systems, concern about the integrity of such systems is not new. After a decade of decline from 2002 to 2012 and despite political attention, higher contributions, and reforms, the funding of state plans did not markedly improve through 2020 (see Figure 1, blue line). In 2020, 60 cents of every dollar contributed to the pension system went to cover legacy pension obligations rather than to cover new obligations of current employees (see Figure 1, orange line).

For years, researchers and organizations have examined different aspects of public pension crises, looking at such topics as the role of actuarial assumptions and, in particular, the discount rate used to compute the present value of liabilities (to determine the extent of liabilities), political involvement and governance, pension portfolio asset allocation, workforce, pension reforms, and legal constraints. However, few studies take a comprehensive view of such crises. Additionally, those studies that do take a broader view are focused on the circumstances around the Great Recession, thereby missing many of the experiences from the past decade.

Without a comprehensive analysis of the challenges, pension system administrators seeking to address their respective crisis lack a solution that considers the full extent of the problem, the underlying causes, the consequences, the array of reform options, the impacts of those reforms, and the elements of implementation that are likely to have the greatest chance of success.

In a recently published report, RAND researchers reviewed existing evidence and spoke to multiple subject-matter experts to better understand public pension crises from a holistic perspective. In untangling the multiple facets that compose such crises, the researchers identified the following six common contributors.

**FIGURE 1**
TRENDS IN PENSION FUNDING

NOTE: The funded ratio is the actuarial value of assets as a percentage of the actuarial accrued liability. This chart represents funding ratios by Government Accounting Standards Board Statement No. 25 (from 1994). Legacy pension obligations are unfunded accrued liabilities. The orange line (right axis) depicts these obligations as a share of the annual amount, determined by a plan’s actuaries, that is required to cover new obligations and pay down legacy obligations over a period of time. The years on the x-axis are the pension funds’ fiscal years, which can vary, but many are from July to June.
“Liability went up . . . but we’re not paying more [benefits]. Instead, we’re recognizing the reality, the fact that the liability has actually been bigger than we said previously. That caused the contribution rate . . . to go up 50 percent.”
—Public pension system administrator

1 | ASSUMPTIONS
One factor contributing to pension crises is the use of inaccurate or overly optimistic assumptions when valuing pension assets and liabilities. Such assumptions include those having to do with economic and demographic issues (e.g., rate of return on assets, mortality and retirement rates, and employee turnover rates) and those having to do with amortization and the rate at which future pension liabilities should be discounted. For example, an overly optimistic discount rate will result in an underestimate of the pension system’s liabilities. Since the annual contribution to the pension system is based on an estimate of the system’s liabilities, underestimating those liabilities can result in contributions that are too low to meet pension obligations.

2 | STRUCTURAL CONSTRAINTS
A pension plan’s institutional setting can affect what policies can be feasibly implemented. For example, unlike private-sector plans that are governed by the Employee Retirement Income Security Act, state and local retirement systems are subject to state and local laws that permit far more flexibility with respect to setting rules and standards affecting their pension systems. In some cases, these laws are restrictive, providing contractual or constitutional guarantees that prevent reductions in benefits for current retirees and, in some cases, for current employees. Because pension benefits for new employees are not protected, benefit reforms in these cases tend to disproportionately target this group.

3 | POOR GOVERNANCE
Governance of public pensions includes four main types of actors: the plan sponsor (e.g., the state legislature), the chief executive (e.g., the governor), the pension board that oversees the management and administration of the pension system, and the pension system actuary. A review of existing research found that a variety of governance concerns—including lack of transparency and accountability, conflicts of interest and incompatible incentives, poorly functioning processes, and poorly defined fiduciary duties—can hamper effective management of public pensions and slow or prevent effective reform.

4 | LACK OF EXPERTISE
A recurring discussion point in the researchers’ conversations with subject-matter experts was the need to educate the community and, notably, pension boards, chief executives, and plan sponsors about the operational, technical, and investment aspects of pension system management. In a few cases, the experts noted that members of pension boards, when pressed, did not understand the consequences of the actuarial assumptions they had previously approved. Other groups lacking relevant expertise included legislatures and key interest groups, such as unions and plan members.

5 | POLICY CULTURE
Existing research indicates that political culture—that is, the degree of cooperation and openness among stakeholders as they seek solutions to the pension crisis—is related to funding outcomes. For example, studies show that more politically
competitive jurisdictions have lower pension-funding ratios and that the likelihood of financially damaging but politically expedient accounting choices increases when the sponsoring government is more divided in terms of partisan control.

Subject-matter experts who reported broadly collegial interactions among stakeholders, regardless of political differences, implied that the pension board and administrative leadership played a role in making reforms. Alternatively, some subject-matter experts noted that local policy cultures were more combative and suggested that the chief executive or legislature took actions independent of the pension board or the system’s administrative leadership. These more-combative policy cultures existed regardless of the political orientation of the party that sponsored the systems.

6 CONFLICTING INCENTIVES AND INTERESTS

Pension boards are often composed of political leaders, plan members, and union leaders—groups that can have incentives (e.g., reelection) that conflict with making policy changes necessary to sufficiently fund a pension plan. Conflicting incentives may be even stronger when reforms require hard trade-offs, leading to actions that delay increasing contributions. For example, prior research has found that having a higher proportion of political appointees on the pension board and having systems in which the workforce is more unionized are linked with the adoption of actuarial assumptions that artificially reduce the appearance of underfunding (e.g., higher discount rates). Other studies have found that conflicting incentives and interests may also lead to poorer or riskier investment choices. For example, state and local pension systems overweight in-state investments, whose performance is 2 to 4 percentage points lower than systems’ own out-of-state investments and similar investments in their state by out-of-state investors. Pension boards may also select riskier asset classes to boost lagging returns.

Ideally, conflicting incentives would be addressed by pressure from groups responsible for their oversight (e.g., for politicians, voters; for pension systems, the participating employers; for unions, employees who are their members). However, the public tends to inaccurately assess the costs and benefits of pensions. With pension costs spread broadly across all taxpayers and employers (in cost-sharing systems), solving a pension system’s funding crisis may be a less prominent concern relative to other competing issues.

“I talk with other executive directors about how we need to build relationships with the governor and legislature and educate them. One legislator said, ‘I don’t understand pensions, but so-and-so does, so if they vote yes, then I vote yes.’ But so-and-so doesn’t actually understand [them] either! We set out on an effort to educate these folks.”

—Public pension system administrator
A Prototype Road Map for Public Pension Reform

DIAGNOSING INDIVIDUAL PENSION CRISSES

In addition to studying the underlying causes of public pension crises, RAND researchers created a prototype framework to help pension plan managers diagnose the causes of their respective pension crisis (Figure 2). This road map takes a holistic perspective that recognizes:

- the array of stakeholders and their incentives, constraints, and time horizons that affect decisionmaking
- the root causes that can lead to bad governance and practices
- the range of alternative reform options and their effects not just on pension financing but on other outcomes of interest, such as the effects on employee retirement savings
- workforce demographics.

The road map can also help stakeholders who want to better understand the dimensions of public-sector pension reform and policy options available to mitigate or avert a crisis.

As noted in the “Lack of Leadership” box and in the second step of the road map (“understand causes”), addressing poor leadership at all levels will be a necessary precursor to implementing successful reforms.

IMPORTANT KNOWLEDGE GAPS STILL EXIST

Because the road map is intended to help guide state and local pension policymakers in their decision-making, it promotes the consideration of feasible and effective reforms that are informed by rigorous research and analysis. These options include not just traditional policy options, such as increasing pension contributions or increasing taxes, but also changing governance, actuarial assumptions, and pension

FIGURE 2
THE PROTOTYPE PUBLIC PENSION POLICY REFORM ROAD MAP HAS FIVE KEY STEPS

1. DEFINE ISSUES
   - Pension crisis definition
   - Who is affected and how
   - Institutional and legal setting
   - Past reforms

2. UNDERSTAND CAUSES
   - Lack of expertise
   - Misaligned incentives
   - Poor accounting practices
   - Dysfunctional governance
   - Mistrustful government culture

3. IDENTIFY GOALS
   - Outcome goals
   - Process goals

4. FIND EFFECTIVE PATHS
   - Pension reform
   - Public finance reform
   - Accounting reform
   - Governance reform

5. IMPLEMENT REFORMS
   - Identify a leader
   - Establish communication plan
   - Track progress and resolve problems
   - Incorporate program evaluation
design. However, because there are still knowledge gaps that are critical to informing would-be reformers, the research team considers this initial road map a prototype. Additional study of the gaps below is needed to provide clearer links between pension reform options and desired outcomes.

**Gap 1 | Effectiveness of Pension Reforms in Reducing Unfunded Obligations**

Despite substantial reform efforts since 2009 (see Figure 3), the funded ratio has remained largely flat since 2015. It is possible that the relatively unchanged nature of pension liabilities reflects a shift toward more-conservative assumptions that would otherwise conceal broad improvements. Alternatively, the shift could be toward other approaches of delaying payment for unfunded liabilities. Or it could be due to local challenges that affect unfunded pension liabilities or due to the sponsor’s ability to ensure that sufficient funds are contributed (e.g., changes in the plan sponsor’s budget, changes in the sponsor’s labor needs).

**Gap 2 | Impact of Pension Underfunding on Employers and Plan Sponsors**

Although there is some evidence that municipalities with underfunded pension systems have higher borrowing costs, evidence is more limited on the relationship between pension underfunding and recruiting for positions covered by the pension system or people’s willingness to stay in or move to these localities.

**Gap 3 | Impact of Pension Reforms on Retirement Security**

A motivation for the creation of pensions in the late 1800s and early 1900s was to encourage older employees to exit work by eliminating the need to work to ensure income. As pensions are reformed toward systems with lower or no lifetime income benefits in retirement, workers may face a greater risk of financial insecurity in retirement. These risks and their potential impact on employers or plan sponsors are not well understood.
Conclusion

Fixing state and local public pension underfunding is complicated, which often means that the issue does not receive the urgent public attention that it deserves. The framework developed by RAND researchers can help stakeholders begin to analyze the causes of the crisis while gaps in knowledge are filled. At the same time, much stronger leadership will be required at the national, state, and local levels to avert worsening crises, avoid a series of large future federal government bailouts, and secure public servants’ retirement savings.