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Unfunded pension liabilities hurt state's bond rating

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Residents of New Mexico awoke to bad news recently after the national credit ratings agency Moody's downgraded the state's bond rating. The lower rating will increase the state's borrowing costs, and is an indication of the state's worsening financial health.

When explaining the rationale for the downgrading, Moody's noted the downgrade "is primarily attributable to the state's extremely large pension liabilities." New Mexico's story is one that is being repeated in states and cities all across the country. The steady growth of unfunded pension liabilities at the state level could be setting the stage for the next Great Recession.

Pensions are retirement funds designed to provide workers with a steady source of income after they retire. In order to fund a pension, employers and employees agree to contribute a certain amount of money to the pension each year, which is then invested in the market. The vast majority of state and local pension funds are run as "defined-benefit" plans, meaning that retirees are guaranteed a certain monthly income regardless of how the pension's investments perform.

Any shortfalls between the assets in a pension fund and the amount that the fund is obligated to pay out in benefits are called "unfunded pension liabilities."

In April of this year, the Pew Charitable Trusts released its annual report on the funding of state pensions, aptly titled "The State Pension Funding Gap: 2016." The report found that state pension funds in the United States had a combined total of $2.6 trillion in assets, and $4 trillion in liabilities – thereby translating to $1.4 trillion in unfunded pension liabilities. This was an increase of $295 billion from the 2015 total of $1.1 trillion, and marked the 15th annual increase in pension debt since 2000.

It's important to realize that these figures were calculated using the assumed rate of return on investments that pensions use. As of 2016, the median assumed rate of return was 7.5 percent.

As the Pew report notes, "even small changes to projected returns can significantly increase liabilities." When using a 6.5 percent return assumption rather than 7.5 percent, projected unfunded pension liabilities jump to $1.7 trillion.

The scariest thing is that using an assumed return rate of 6.5 to 7.5 percent could be optimistic. In a recent NASDAQ article, Matthew Blume estimated that total unfunded pension liabilities are currently around $8 trillion when using a more conservative assumed rate of four percent. To put the sheer size of this issue in context, the combined 2017 revenues of state and local governments in the US totaled

approximately $2.6 trillion. So hypothetically, state and local governments could owe pensioners almost four times their total yearly revenue.

Indeed, a conservative assumption for rate of return may be appropriate. As the Pew report noted, “public pensions in the aggregate missed their return targets in five of the preceding 10 years.”

Given the fact that we are currently in the second longest period of economic expansion in US history, and have been in a bull market for over nine years, it's not unreasonable to predict some leaner times ahead.

Should an economic recession sufficiently depress investment returns, it could set off a chain reaction of catastrophic effects. State and local governments with ballooning unfunded pension liabilities would face some unsavory options: dramatically raising taxes, cutting spending, or committing to deficit spending. The former options would suppress economic growth and cause a deeper recession, while deficit spending would only serve to worsen the government’s long-term fiscal position.

Given the fact that this pension crisis would affect states and municipalities across the country, it could very well be viewed as a systemic risk to the national economy. If the crisis proved unmanageable for state and local governments, we could see a federal bailout like we did in 2008.

Yet even absent a catastrophic pension crisis, the growth of unfunded pension liabilities has a number of deleterious effects, ranging from budget cuts and public safety layoffs to downgrades of state and city creditworthiness.

In California, Santa Barbara County has already started to feel the squeeze. Facing almost $700 million in unfunded pension liabilities, the county was forced to lay off nearly 70 social service workers in 2017 after being forced to reallocate $11 million of its budget toward pension expenses. Other departments such as the sheriff’s office and the county’s probation department also saw funding cuts as a result of the reallocation.

No matter how optimistic or conservative you are, it's clear that many of our states and localities have serious pension funding issues. Resolving these issues will be difficult, but as President Kennedy once said, “the time to repair the roof is when the sun is still shining.” We must work to fix our pension system while still in the sun of economic expansion, or risk flooding the house when the next recession hits.

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