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Awash in Cash: It’s a Good Time for States to Bend the Pension Cost Curve

National Conference of State Legislatures
Regional Fiscal Leaders Meeting
June 10, 2022

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Overview

- States are meeting minimum contribution standards thanks to a decade-long process of reform and fiscal discipline.

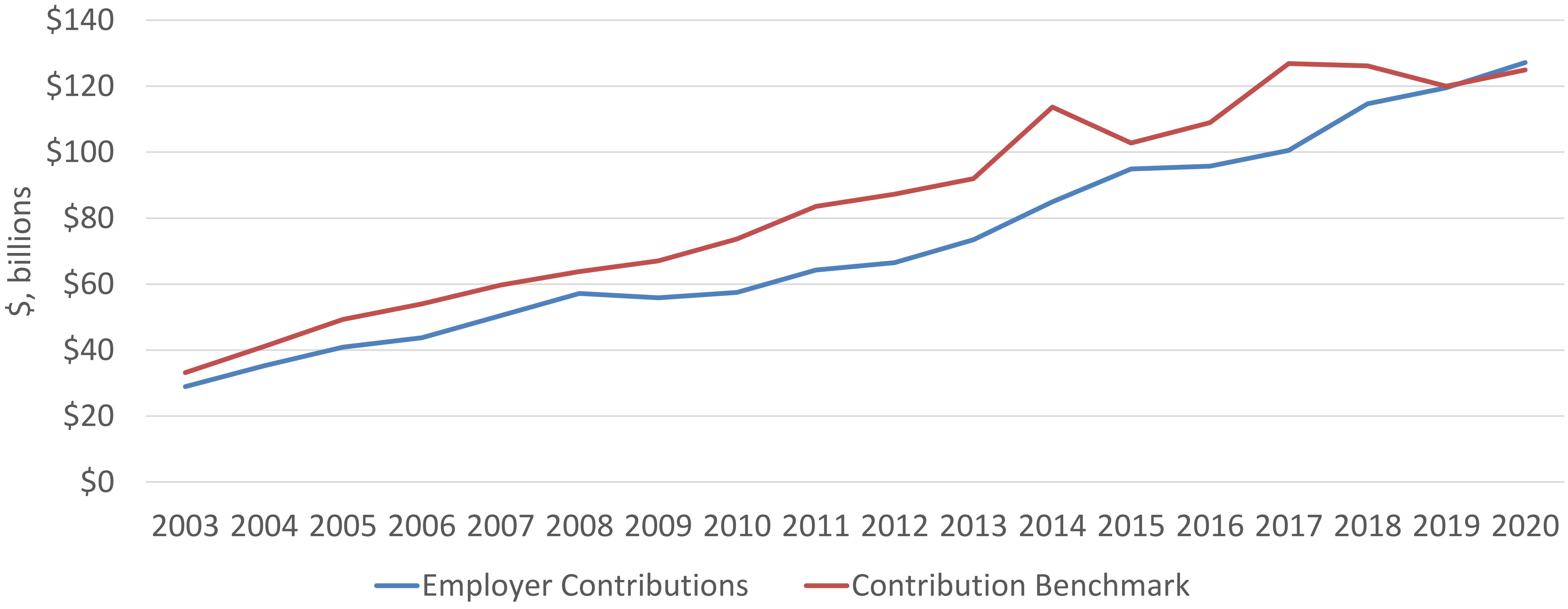
- Combined with once-in-a generation investment performance in FY 21, state pension debt has stabilized.

- States have a window of opportunity to put in place measures to stabilize future costs and ensure long-term pension sustainability.

- Policymakers have already taken important steps to do so and we’ve found a range of promising practices worth considering.

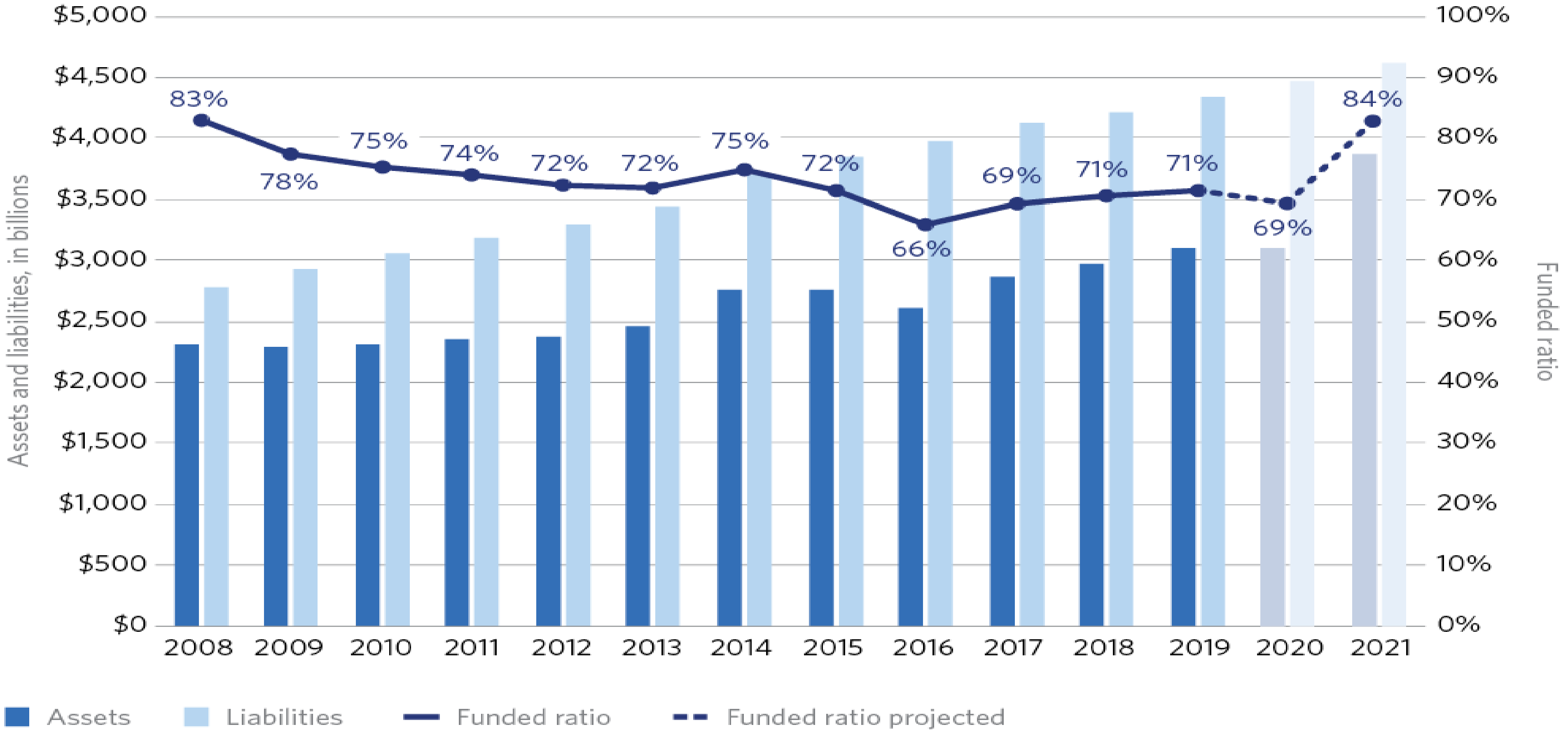
States have made significant progress

Employer pension contributions have quadrupled since 2003 and now are meeting minimum contribution benchmarks.



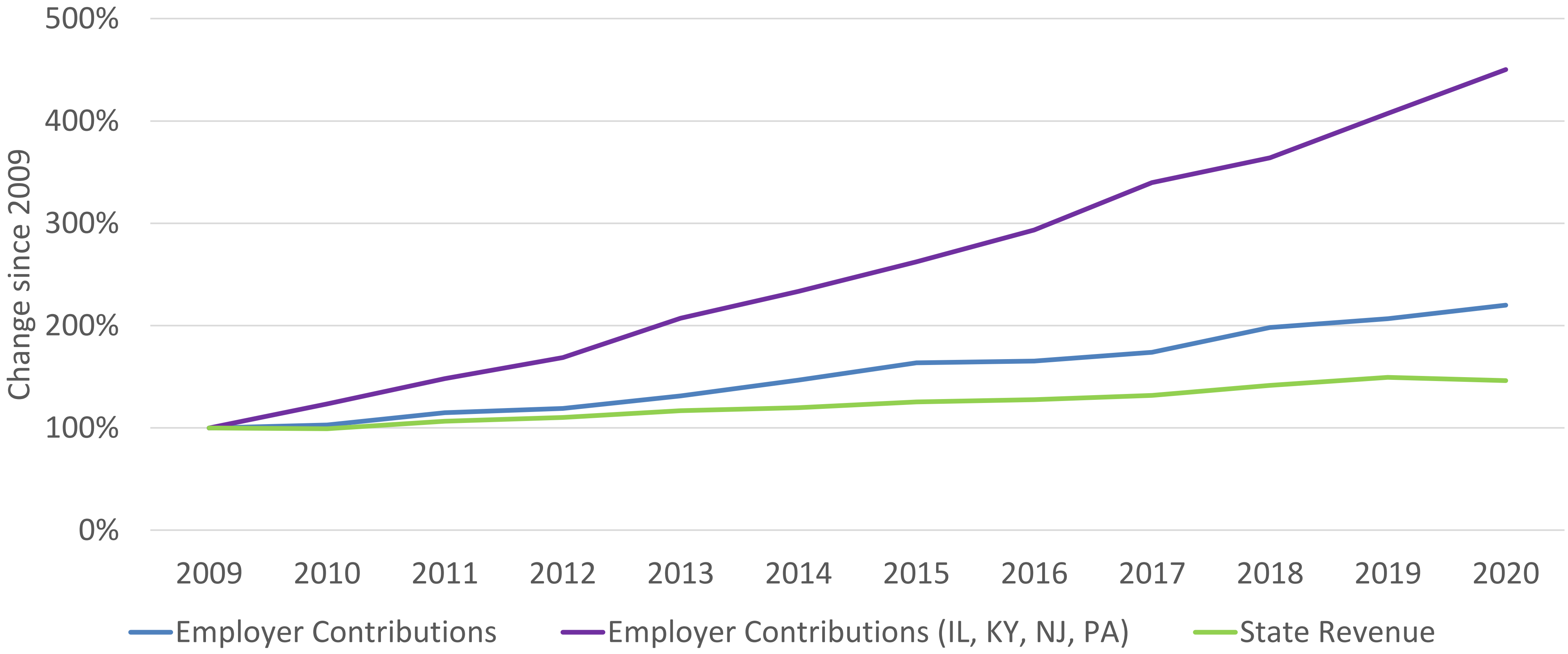
State pension funding gap stabilized

Once-in-a-generation returns have brought the funded ratio back to 2008 levels.



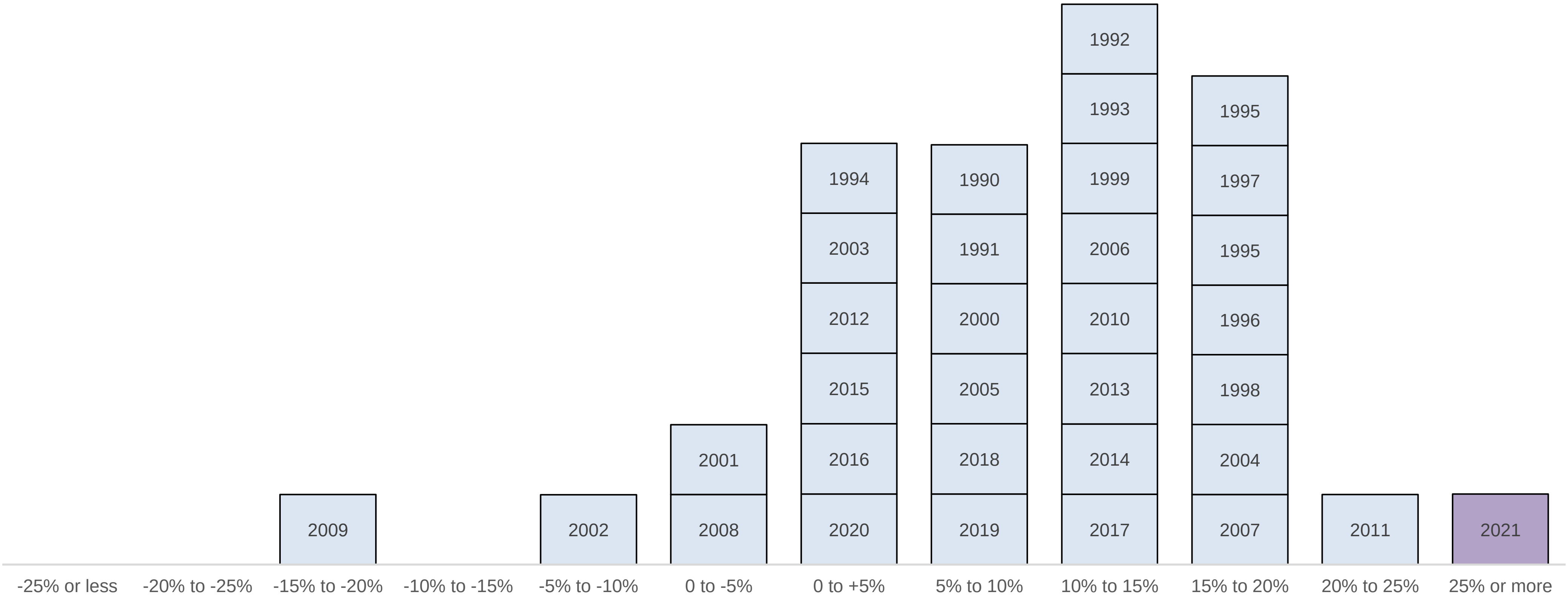
A growing share of state resources to pensions

Contributions grew twice as fast as revenue since 2009; biggest increases in states that needed it most.



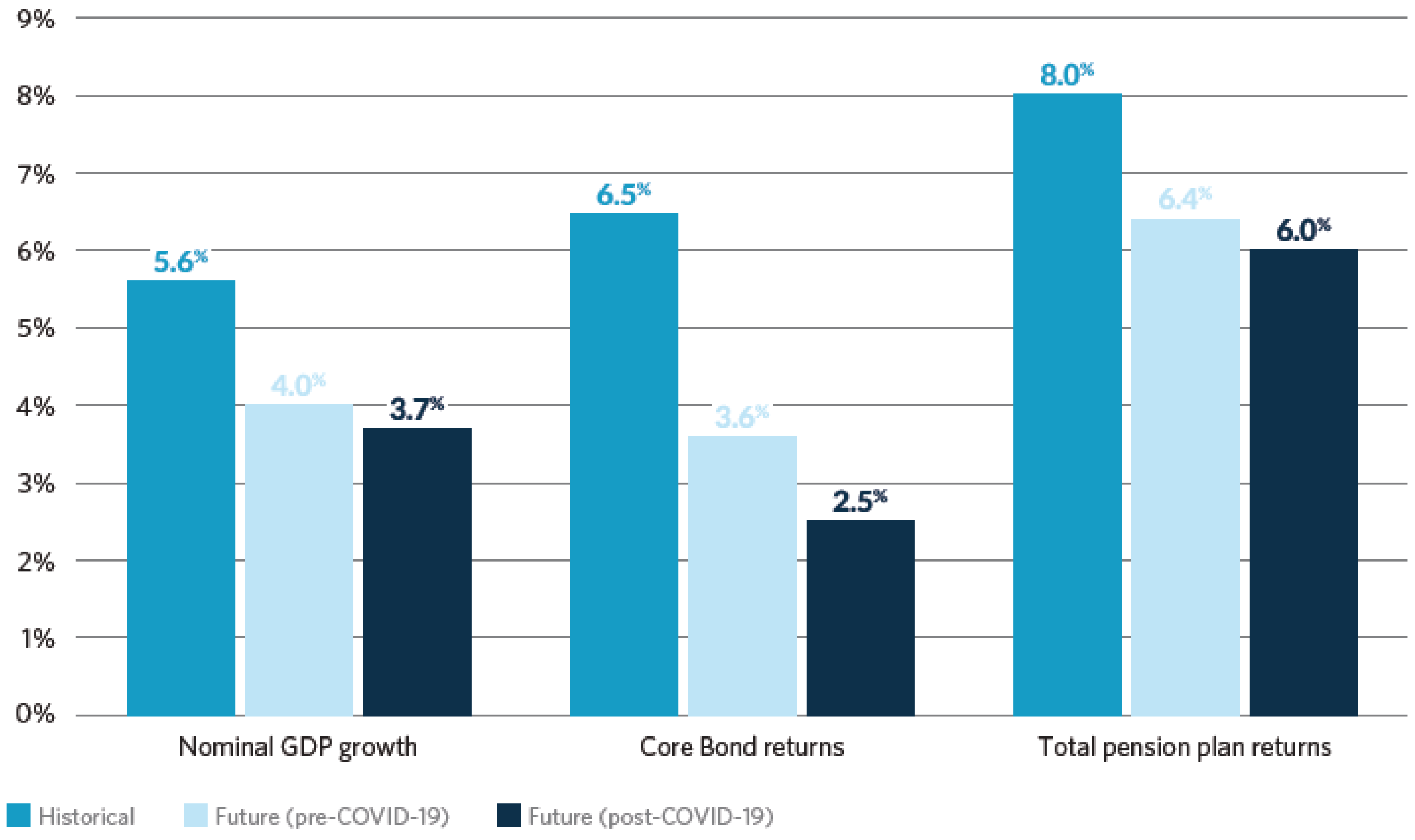
Once-in-a-generation returns

While strong returns in 2021 will help public pension balance sheets, states cannot count on future investments to fill the remaining hole.



Long-run expected annual return

Expected returns continue to decline despite recent market rally



States have a window of opportunity

- Improved funding policy and strong investment returns have stabilized pension debt.

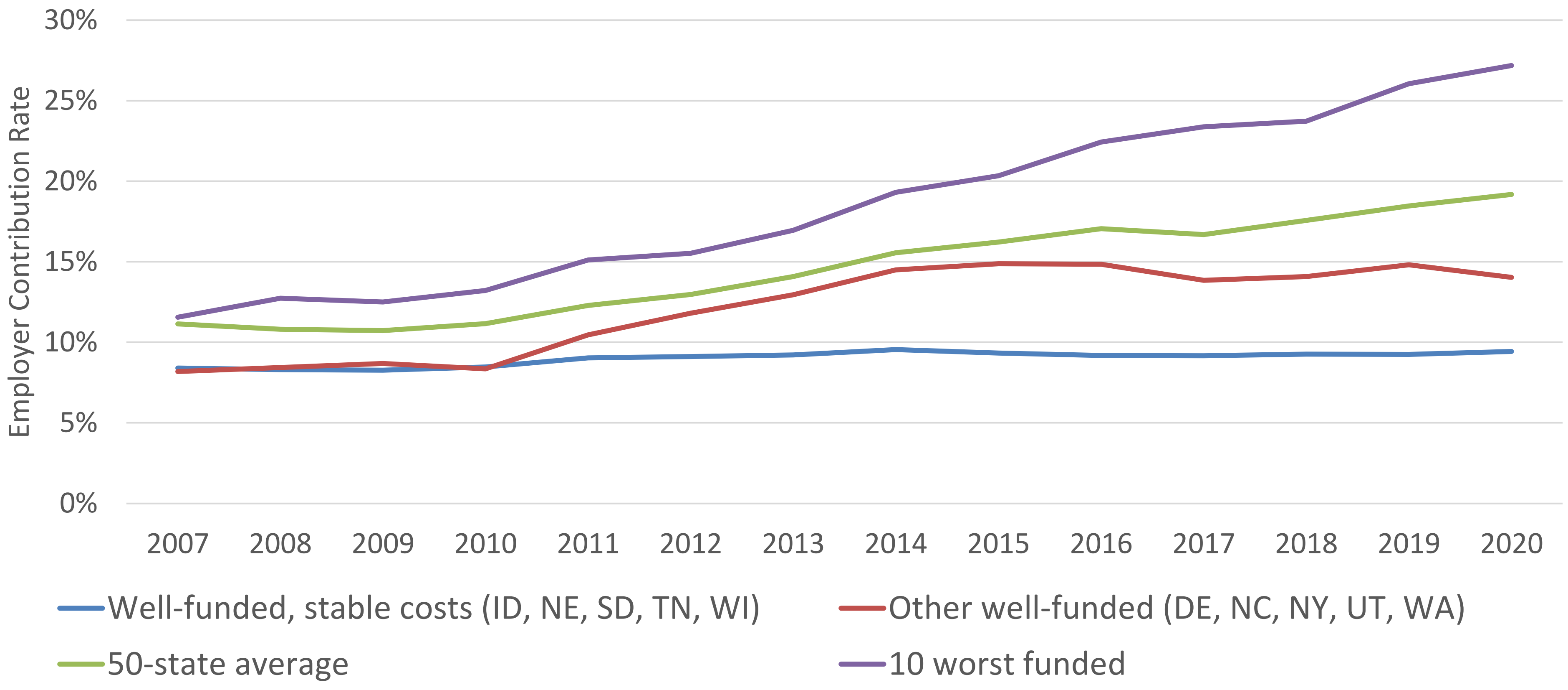
- States have found themselves with higher-than-expected revenues and budget surpluses.

- Recent turmoil in financial markets is a reminder of risk.

- Policymakers can use windfalls to build long-term pension sustainability.

Good policy can make a difference

Fiscally-sustainable pension policy can keep costs stable while maintaining high funded levels.



Promising practices

State policymakers are already building on success to strengthen the long-term sustainability of public pensions. What are some promising practices?

- Funding above the actuarial contribution
- Lower return assumptions
- Use variable benefit provisions
- Conduct stress testing and risk analysis

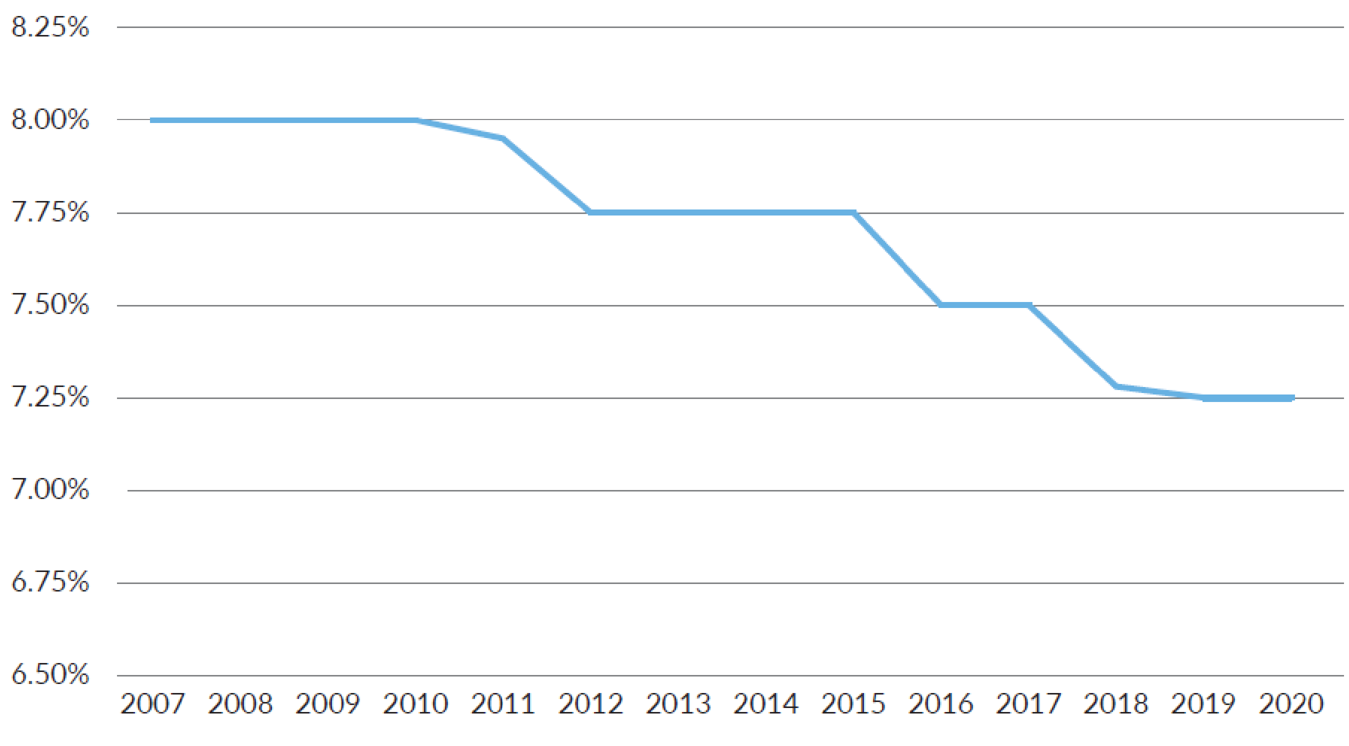
Pay above the actuarial contribution

- In 2021, Connecticut put an additional $1.6 billion into its pension plans above and beyond the actuarial contribution recommendation.
- Arizona, California, Kansas, Illinois, Indiana, New Jersey, Tennessee, and Vermont have made similar payments.
- Making additional contributions when states have available surpluses both strengthens public plan balance sheets and will save taxpayers money in the future.
- Using a reserve fund, as Tennessee does for its hybrid plan, can provide additional stability.

Lower return assumptions

Since 2015, 46 states have lowered the assumed rate of return for one or more of their pension plans.

Median fund assumed rate of return, 2007-20



Sources: Comprehensive annual financial reports; news articles; and plan responses to data inquiries

Use variable benefit provisions

- Alabama, Louisiana, Ohio, Oklahoma, Texas, and Washington have recently provided one-time or ad-hoc COLAs in light of both the improved funding situation and higher than expected inflation.

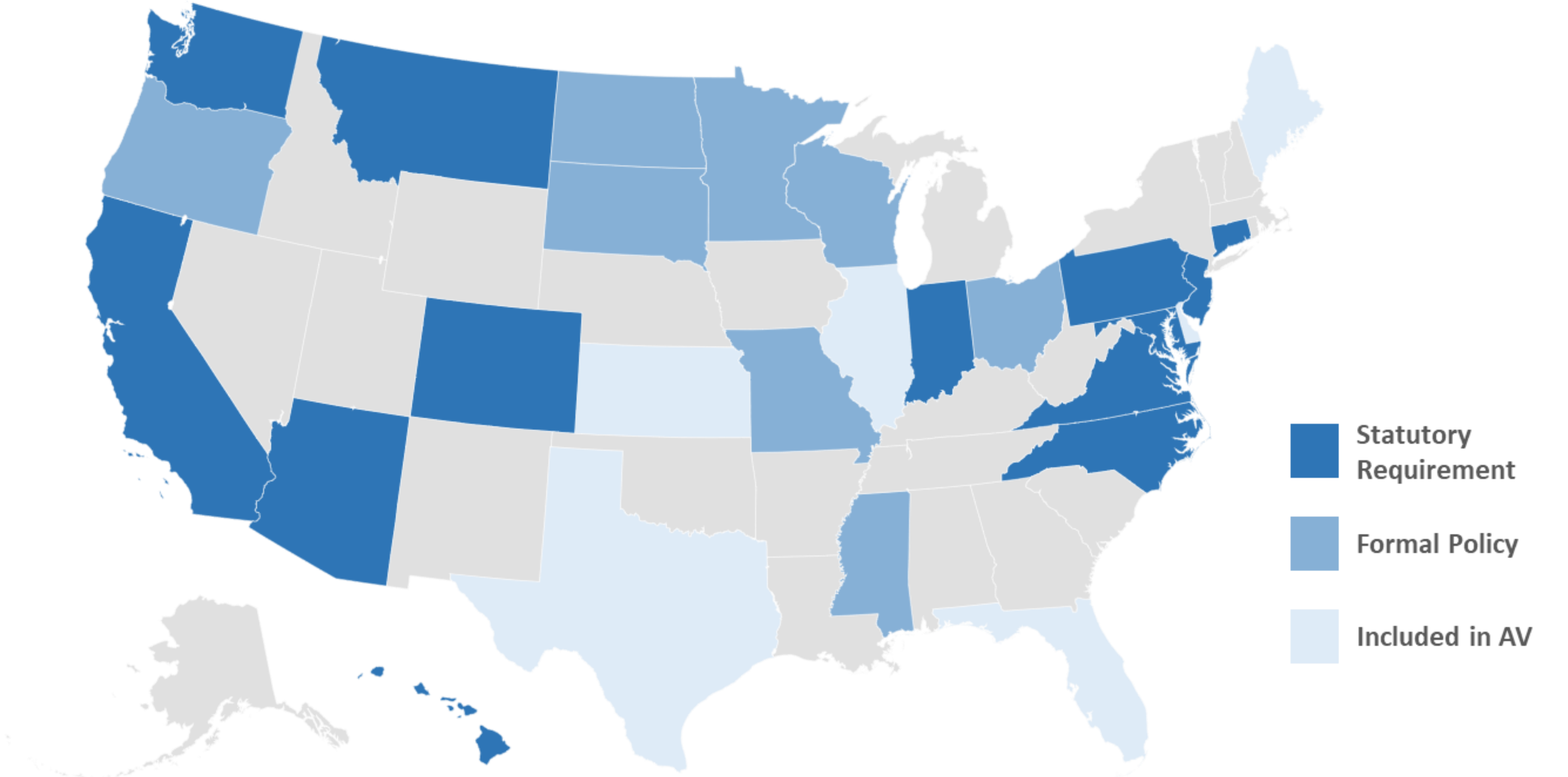
- If policymakers are considering making these COLAs permanent, examples of variable COLAs can offer a useful model.

- Wisconsin and South Dakota have used variable COLAs to both share risk and provide meaningful inflation protection to retirees.

- Other states have used variable benefit provisions to make retirement costs more predictable without needing to dramatically cut back benefits.

Conduct stress testing and risk analysis

More than half of states now have some form of forward-looking pension analysis that incorporates investment risk.



Key takeaways

- A decade of reforms, including significant increases in pension contributions, combined with windfall investment returns have stabilized pension debt.
- State pension plans remain dependent on volatile and risky financial markets though good policy can offer stability.
- Policymakers have a window of opportunity to strengthen the long-term sustainability of public pensions and states continue to offer an array of promising practices.

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https://www.pewtrusts.org/en/projects/public-sector-retirement-systems