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# State And Local Pensions: What Now?

STATE AND LOCAL  
PENSIONS

WHAT NOW?



ALICIA H. MUNNELL



## Synopsis

In the wake of the financial crisis and Great Recession, the health of state and local pension plans has emerged as a front burner policy issue. Elected officials, academic experts, and the media alike have pointed to funding shortfalls with alarm, expressing concern that pension promises are unsustainable or will squeeze out other pressing government priorities. A few local governments have even filed for bankruptcy, with pensions cited as a major cause. Alicia H. Munnell draws on both her practical experience and her research to provide a broad perspective on the challenge of state and local pensions. She shows that the story is big and complicated and cannot be viewed through a narrow prism such as accounting methods or the role of unions. By examining the diversity of the public plan universe, Munnell debunks the notion that all plans are in trouble. In fact, she finds that while a few plans are basket cases, many are functioning reasonably well. Munnell's analysis concludes that the plans in serious trouble need a major overhaul. But even the relatively healthy plans face three challenges ahead: an excessive concentration of plan assets in equities; the risk that steep benefit cuts for new hires will harm workforce quality; and the constraints plans face in adjusting future benefits for current employees. Here, Munnell proposes solutions that preserve the main strengths of state and local pensions while promoting needed reforms.

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## Customer Reviews

Covers the issues facing public pensions today in depth. Fact based approach and non political. Covers funding models, pros and cons of pensions and the accuracy of common conceptions about pensions.

The exhaustive work by Alicia H. Munnell on the pension history, landscape, etc. is an in-depth look at one of the factors that is causing state and local govt expenditure demand to rise faster than revenue growth. I have found the data and insights to be very useful.

I bought this book after reading Munnell's *Falling Short*, which is based on retirement in general. Both are excellent books. The facts are well presented with a historical perspective to guide the use toward their meaning. There is little here in the way of opinion which is refreshing.

This is one of the most important subjects in current public policy debate. Professor Munnell's work is thorough and thought-provoking. She is correct in asserting that a handful of very poorly defined benefit plans have given all a bad name. That said, she does see the potential use of hybrid plans that combine defined contribution and defined benefit components. She is correct in asserting that switching to DC plans does not take jurisdictions off the hook for prior liabilities. But she understates the political and substantive draw of ending the balance sheet risk that future generations won't face through such a transition. In a similar vein, I agree with her that reduced benefits may make the public sector less appealing to younger workers. But the question may be whether the millennial generation will tolerate 6-10 year vesting periods attendant to the DB plans. Munnell asks if the public groundswell to cut public pension is in part a race to the bottom in which all Americans are seeing an increasingly bleak retirement. That is a fair question to ask. I don't think she provides an answer. She does raise a broader question about the need for a third tier of retirement savings built around a portable DB model. Senator Harkin introduced legislation that would establish such a plan. It won't see the light of day, but it suggests Munnell is putting the current public pension mess into broader relief.

An authoritative, comprehensive, insightful book for those studying the economic of public finance

aspects of state and local pensions. Munnell covers many issues. I'll comment on one, the appropriate discount rate. She states, correctly, that virtually all pension economists say that since pension obligations are secure, the discount rate to use for calculating the present value of liabilities should be a safe rate, such as treasuries or perhaps AAA corporate bonds. Accountants, and every public pension plan I know of, use the expected return on assets. The modal value is 8%. Munnell suggests a compromise: use the safe rate for reporting funding, use the expected return for the annual required contribution. All three--pension economists, accountants, and Munnell are wrong, however. The actual obligation is (chiefly) to an intermediary, the future taxpayer. If utility-maximizers, future taxpayers are willing to bear some risk (more a tax-distortion risk than a portfolio risk, Lucas & Zeldes AER--who for some reason test empirically a model they maximize over one variable instead of the appropriate two). With back-of-the-envelope calculations, I propose the correct discount rate is around 7% currently, depending on the curvature of tax distortions. Why not the Munnell compromise? Who's going to pay attention to it if it doesn't affect the ARC--just another number to ignore. That, and the true obligation is mainly to the future taxpayer--shared slightly with current recipients and just a little more with current employees. All those who write on the discount rate, including Munnell, state in passing that the future taxpayer is at risk, and then ignore that fact. Rauh & Novy-Marx, for example. (I'm taking advantage of the opportunity to express a view on one issue, a fraction of the book.)

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