State and Local Retirement Plans: Implications for Government Budgets

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How important is the State and Local sector?

State and local expenditures out of own funds
Share of GDP

- Medicaid/Other Health: 17%
- Public Safety: 13%
- General Gov: 7%
- K-12 Ed: 29%
- Other: 19%
- Higher Ed: 15%
Weak State and Local recovery

Real Spending on goods and services relative to 2007 Q4
S&L spending excludes spending on transfers (like Medicaid)
Sources of stress on State and Local budgets

Employee pensions and retiree health programs

Medicaid

Declining Federal Grants

Explicit Debt
Employee pensions and retiree health programs

Various Measures of Unfunded Liability:

Pensions: $4 trillion in 2015 (Rauh) $1.6 Trillion 2017 (FRB, Financial Accounts)

Retiree Health: $1.2 Trillion (Lutz and Sheiner, 2014)
Unfunded liabilities and fiscal challenges

Unfunded liabilities not necessarily problematic: Pay-as-you-go systems—which have unfunded liabilities—can be sustainable

Not fully funding = deficit financing. Can makes sense:
• If spending on investment (e.g. education)
• During recessions

Probably not necessary to work off existing implicit debts
• Exceptions might be when debt gets so high that borrowing costs skyrocket
• Otherwise, spread costs equally across generations
Is the implicit debt sustainable?

Analogy to sustainable social security system:
◦ No assets, but sustainable if rate of return on contributions equals labor force growth \( n \) + labor productivity \( g \), instead of interest rate \( r \).

◦ Usually assume \( r > (n+g) \) although not true lately and barely true in CBO long-term forecast.

◦ If true, contributions > present value of benefits in stable system.

In pension terminology:
◦ Keeping implicit debt/GDP ratio constant means contributing normal cost (present value of accrued benefits) \( \text{plus} \ (r-n-g) \times \text{Implicit Debt} \).
Assumes 1 ppt increase in discount rate raises normal cost 12 percent. Plan average is asset-weighted average real assumed rate of return from Boston Center on Retirement public plan database from 2001-2016.
Implicit primary deficits (unfunded part of normal cost) as share of GDP
Unfunded liability share of GDP (BEA discount rate)

FRB, Financial Accounts of the United States
Interest rates and GDP growth – CBO projections

![Graph showing interest rates and GDP growth projections from 2016 to 2046. The graph includes two lines: one for Ten-year Treasury and another for Nominal GDP.]
Using BEA discount rate:

Primary deficits from S&L pension plans about .2% of GDP or 2% of own tax revenues (own revenues 9% of GDP in 2017)

Implicit pension debt about 8% of GDP
  If $r-n-g = \frac{1}{2}$ percent, cost is .04% of GDP, or ½% of own tax revenues.

Lutz and Sheiner analyzed required increase in contribution to make retiree health sustainable *in perpetuity*. Found states and localities need to increase contributions by about .1% of GDP, or 1% of own tax revenues. Less if increased retiree health insurance value lowers cash wages.
Current pension contributions likely putting pressure on other spending

Pension Contribution Share of GDP
But pensions (and retiree health) have become less generous

Employer Share of Normal Cost as Share of GDP

If normal cost continues to decline—and there is no offset in non-pension compensation—provides room for states to increase contributions without cutting other spending or raising taxes.
Accrual vs cash accounting

Federal government:
- Mostly cash accounting.
- Deficits associated with Social Security and Medicare projected for future, not accounted for as part of current deficit.
- We have better sense of when problems will arise looking at it this way.

State and Local:
- Mostly cash accounting as well.
- Focus on present value for pensions can be misleading and doesn’t give any sense of the timing of when plans will run into trouble.

Recent papers by Farrell and Shoag, Boyd and Yin examine annual flows but focus on risk of equity investments.

More work needed on long-term annual projections for the sector.
Medicaid also putting pressure on other S&L spending

State Medicaid Spending (share of GDP)
Medicaid source of long-term challenges

State Medicaid Spending (share of GDP)

- Baseline (CBO)
- Growth 1 ppt slower
- Growth 1 ppt faster
Implications for federal government: Direct effects

- Direct effects likely minor:
  - S&L gov’s can take some steps to reduce generosity of pension accruals: increase required service, eliminate COLAs.
  - Might encourage less early retirement, but unlikely to have large effect on Social Security.

- Reduction in interest rates make pension benefits more valuable.
  - If increase in value of benefits offset by reduction in cash wages, might affect wage base for Social Security.

- States have the ability to reduce or cut retiree health benefits.
  - Might have some effect on enrollment in exchanges, but (1) income for most retirees too large to get significant subsidies and (2) early retirees might depend on spousal income for health insurance.
Implications for Federal Government: Indirect Effects

- Fact that S&L governments also face fiscal challenges matters for how think about ease of addressing it.

- Federal reductions in nondefense discretionary (not taken into account here) harm S&L budgets.
  - Non-Medicaid grants, about ¼ of own tax revenue, already about ¼ ppt of GDP lower in 2016 than historical average, and projected to decline substantially over remainder of decade.

- Raising taxes more difficult if S&L govs already raising taxes (and vice versa).

- Cutting federal share of Medicaid also difficult.
Conclusions

Unfunded liabilities from S&L retirement plans very much like a stock of debt.
Analyzing them this way makes them less daunting.
Still, S&L governments will have to make some adjustments going forward.
Magnitude probably much less than the adjustments that will be required in the federal sector.
Probably not much direct impact from changes in state and local government retirement plans on the federal budget.
But the fact that there will be sizable fiscal challenges at the state level at the same time as at the federal level means that everything becomes harder.