

Three U.S. Public Pension Points To Watch In 2025

February 4, 2025

Key Takeaways

- We expect U.S. public pension funded ratios will generally improve when measured as of the fiscal year ended June 30, 2024, and continue to improve in fiscal 2025 because of positive market results in the first half.
- U.S. public pensions face growing risks because assets funding the plans are based on increasingly diverse and opaque allocations.
- We expect pension contributions will increase due to inflation-driven salary growth, partially offset by cheaper new benefit tiers, a frequently used tactic that may no longer be viable.

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Funded Ratios Will Likely Continue Their Upward Trend

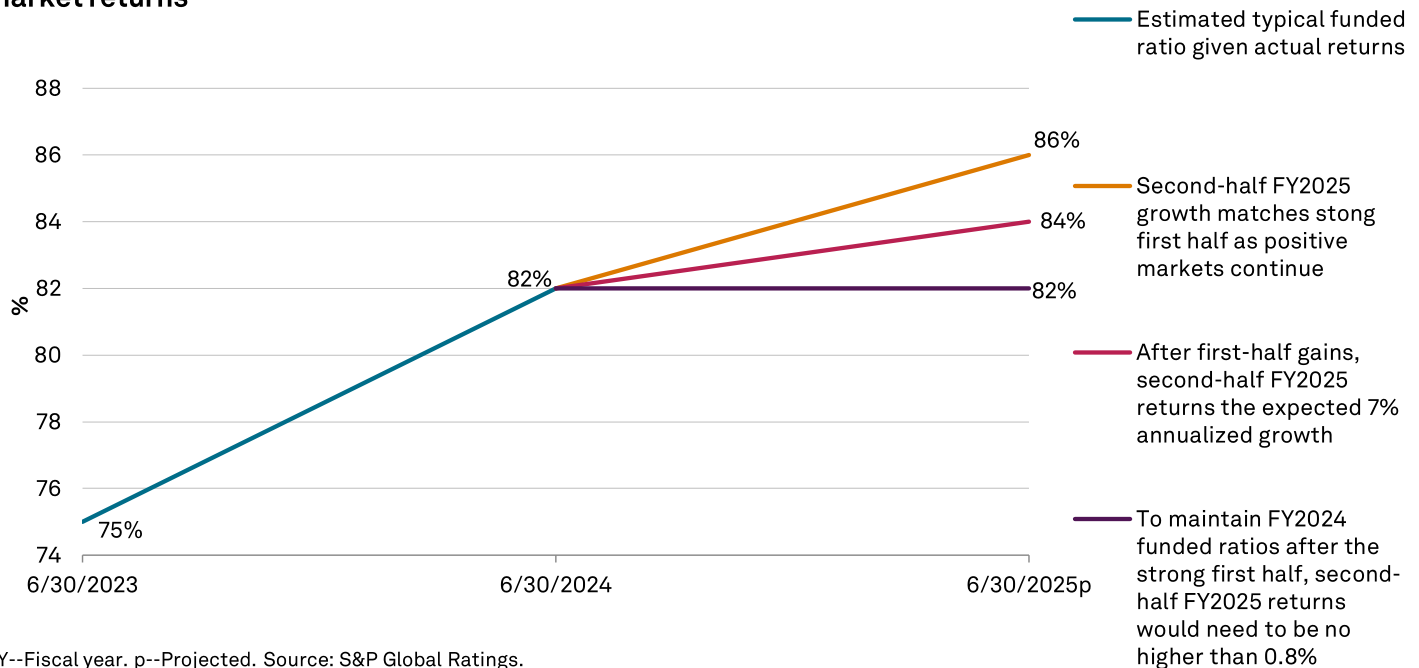
S&P Global Ratings expects continued asset outperformance will spur a notable improvement in U.S. public pension funded ratios reported in fiscal 2025. This upward trend, we believe, will continue in fiscal 2026 because positive market returns are exceeding expectations through the end of calendar 2025.

We note that the pension funded ratios in any given fiscal year are typically represented in an entity's audit for the following year. For example, a 75% average funded ratio as of June 30, 2023, is typically reported in an audit ended June 30, 2024 (see "U.S. States' Fiscal 2023 Liabilities: Stable Debt, With Pension And OPEB Funding Trending Favorably," Oct. 23, 2024, on RatingsDirect). We expect 2025 government audits will reflect the large improvement estimated in chart 1, with the average funded ratio closing in on 82%. We then project to June 30, 2025 (and hence the 2026 issuer audits) using three funded ratio scenarios (as noted in the chart legend) based off of positive first-half returns.

U.S. pension plans assume annual asset returns of 7%, on average, and returns above or below this assumption equate to a "gain" or "loss" compared with planned inflows that might affect contributions and credit stress. We estimate that a typical public pension plan will report a gain in 2025 issuer audits due to a return of approximately 15% as of June 30, 2024. Positive returns are also likely in fiscal 2026 thanks to a return of about 6.1% through Dec. 31, 2025 (over 12% annualized), currently representing a gain since it is above the half-year assumption of 3.5% (annualized to 7.0%).

Chart 1

Continued U.S. pension funded ratio improvement from multiple years of strong market returns



FY--Fiscal year. p--Projected. Source: S&P Global Ratings.

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Hidden risk in asset portfolios could lead to contribution increases

Although recent asset returns have been positive overall, pension funds are taking on more risk to meet their return assumptions by increasing their allocations toward private equity, complex derivatives, and other investments. Public pension plans' allocations toward private equity have nearly doubled in the past 10 years, a problematic trend since these investments often have opaque and variable disclosures and increasing fees, meaning that risk versus return might be hard to measure (that is, the plan's discount rate might not accurately correspond to investment risk).

The discount rate used to measure pension liabilities is based on assumed long-term inflation plus a "return-seeking" component that incorporates market risk. We expect inflation will continue to drop, which could lead to increased contribution volatility, though the decrease is likely to be more gradual than our previous expectation (see Economic Outlook U.S. Q1 2025: Steady Growth, Significant Policy Uncertainty, Nov. 26, 2024). Moderating inflation will eventually lead to plans reducing their long-term inflation assumption, which could pressure plan sponsors because they would face a choice between higher expected costs due to a lower discount rate or additional market risk if they maintain the discount rate. Plans with contributions based on an actuarial recommendation are more likely to make meaningful progress than plans with statutory (or fixed-rate) contributions since they more quickly adjust to changing funding needs, but this also means these plans might experience budgetary stress sooner given adverse experience.

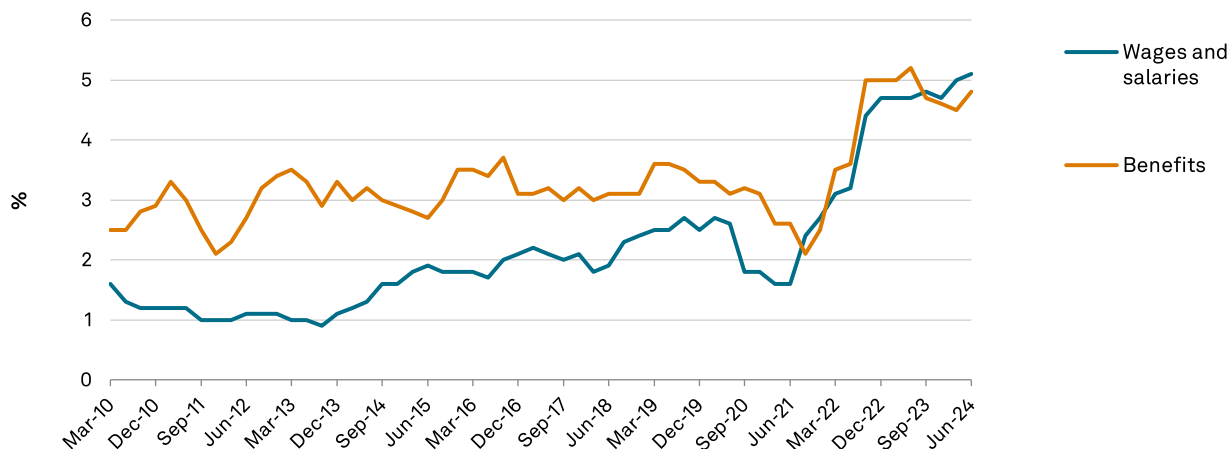
On the other hand, plans with statutory/fixed-rate contributions might put off addressing the need for higher contributions, which could compound these issues with underfunded contributions leading to deferred and growing cost obligations.

Growing wages increase pension costs, which could be partially contained by cheaper new benefit tiers

Many pension contributions are calculated on a percent-of-payroll basis, so for governments sponsoring these plans, increasing wages directly raises contributions. Since pension benefits are typically calculated as a function of salary, increasing wages means an active participant's future benefit payments are also increasing and this is represented as a growth in liabilities. This means that wage increases, and their associated liability increases, could lead to higher costs in the future as benefits being accrued by active participants escalate. Over the past 15 years, we've seen pension payments rise faster than salaries, but this gap appears to be closing. A situation of pension costs determined to be unaffordable by states and local governments has led to a prevailing trend of plans instituting cheaper benefit tiers for new hires. Down the road, the cheaper future benefits stemming from these new tiers could result in increased benefit affordability when compared with salaries.

Chart 2

Wages/salaries and benefits for state and local government, 12-month % change, not seasonally adjusted



Source: Bureau of Labor Statistics, S&P Global Ratings.

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However, due to attraction and retention pressures states and local governments face, the ability of plans to add cheaper new benefit tiers could be limited, or no longer a viable option, with some plans even looking to undo recent cost-saving changes so they can increase benefits for recent hires. Such increases are not easily reversed, and plan affordability changes on a year-to-year basis, so although reverting to higher benefit plans could lead to better hiring outcomes, they could, in turn, result in higher costs.

Related Research

- Economic Outlook U.S. Q1 2025: Steady Growth, Significant Policy Uncertainty, Nov. 26, 2024
- U.S. States' Fiscal 2023 Liabilities: Stable Debt, With Pension And OPEB Funding Trending Favorably, Oct. 23, 2024

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