The Impact of Inflation on Public Pensions

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As consultants and advisors to public pension plans, we often receive this fair and intriguing question from stakeholders: “What impact will high inflation have on public pensions?” In this article we provide the most common considerations.

Cost-of-Living Adjustments (COLA)

Some plan designs tie increases to annuities in payment status to changes in the consumer price index (CPI). While many of these designs include “caps” or are based on a portion of CPI changes, the current level of inflation will likely generate additional unfunded liabilities for these plans. This could translate to a higher required contribution or delay the number of years until full funding. While a sizeable number of plans (47% of those providing increases, according to the June 2022 NASRA Issue Brief) provide automatic COLAs linked to inflation, many plans do not provide automatic increases or offer a fixed increase that is not tied to inflation. Most plans will see a decrease in purchasing power for their current retirees.

Salaries

Conventional economic theory states that a portion of an employee’s annual salary increase is tied to current inflation. However, with CPI up over 9% for the year that ended in June, it is unclear how much of that will flow through to employees via wage increases, and how quickly. Larger-than-expected increases in salaries could result in increased unfunded liabilities and higher levels of “normal cost” funding. However, as many public systems receive contributions tied to payroll, if higher-than-expected contributions exceed the Actuarial Determined Contribution in expected dollars, that would partially mitigate the increase in unfunded liability.

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Investment Return

Considering that nominal returns on investments can be thought of as real returns in excess of inflation, pension funds' total portfolio returns may be expected to increase in periods of high inflation. However, real returns on equities and fixed income are more nuanced and are subject to volatility from several economic factors. High inflation can be correlated with lower equity returns and can also erode the value of bonds that are not indexed to inflation. Other investments, such as commodities, may increase in value during periods of high inflation.

Demographics

Periods of high inflation may also have demographic effects. If active membership decreases due to layoffs, costs could be lower in the long run, but be inflated in the short run as a percentage of payroll (or result in a decreased contribution base), particularly for legacy unfunded liability. Delayed retirement dates caused by higher prices of consumer goods and healthcare could result in shorter periods of retirement and a decrease in unfunded liability, partially offset by potentially increased monthly benefits.

The Bottom Line

Except for some COLA designs and potential investment impacts, periods of high inflation generally do not have a direct, immediate impact on public pensions. Typically, the effect is delayed and is based on other factors related to inflation; and may not have as great an impact on plan costs as the prices of goods and services.

To understand the potential impact, plan sponsors and their actuaries could thoughtfully model projection scenarios where these factors are considered. However, the true impact will only be determined in hindsight as actual experience emerges over time. ◆

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