POLICY BRIEF

Funding Public Pensions

Is full pension funding a misguided goal?

BY TOM SGOUROS

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TABLE OF CONTENTS

Abstract **4**

The problem: underfunded pension systems **5**

Why are there accounting rules? **7**

Problems with accounting rules **9**

- Legal: Governments will not be liquidated 10
- Chronological: Present value masks the level of urgency 11
- Actuarial: Full funding is not required to pay all pension debts 12
- Mathematical: Financial reports deserve more precision 14
- Financial: Rate of return is for the longest term. 14
- Economical: Comparisons to pension debt should be chosen properly 16
- Political: Overfunding is a risk, too 16
- Philosophical: A pension plan is a mutual, not individual, arrangement 18

Other post-employment benefits crisis **19**

Common “solutions” that seldom solve anything **20**

- Pension obligation bonds: Investing on the margin 20
- Closing a plan: Riskier than you might think 21
- Defined contribution pension plans: Not really a pension, or a solution 22
- Potential solutions: different accounting for different questions 24

Arguments against **25**

- Facing facts: On not kicking the can down the road 25
- Budgeting: Full funding reduces volatility 26
- Accounting clarity: What questions can you answer? 27

Conclusion **28**

Endnotes **30**

Appendix **35**

ABSTRACT

Public pension systems across the United States are, and have been, in crisis. But, to a larger extent than is widely acknowledged, the crisis is the result of the accounting rules governing both these plans and the governments that sponsor them. These rules are designed to insure against risks that public pensions systems do not face, while simultaneously failing to insure against the risks they do face. The rules also encourage "reforms" that frequently do not improve the financial situation of a given pension system. This is not just deplorable, but a recipe for making a bad situation worse—precisely what we've seen over the past few decades. A hybrid accounting system could provide a more accurate picture of a system's financial health while reducing the waste of overfunding. It could relieve unnecessary financial pressures on thousands of governments across the nation while still preserving the integrity of their pension systems.

THE PROBLEM: UNDERFUNDED PENSION SYSTEMS

Across the nation, public pensions are in crisis, and have been so for a long time. Funding pension costs is a political issue in cities, counties, and states from California, to Illinois, to Rhode Island. The rising expense of public employee pensions has become a political hot button justifying cuts to education and other necessary government investments, causing acrimonious debate, court cases, protest marches, and more. All the recent incidents of municipal bankruptcies have been blamed, at least in part, on pension obligations. Most famously, this was the case in Detroit, Michigan, but has also been true in the cities of Stockton and Vallejo in California, Prichard, Alabama, and Central Falls, Rhode Island.

The city of Chicago is currently feeling some of the warning tremors. According to its own estimates, the city's various pension funds have only half the funds in hand needed to pay its pensions. This leaves a $28.6 billion difference between the assets and the present value of the debt to all the current and future retirees in the system.[1] This difference, known as the "unfunded liability," was cited as the primary reason that Moody's, the bond-rating firm, downgraded Chicago's bond rating to "junk" status in May of 2015.[2]

The other common measure of a pension system's health is the ratio between the assets and the future liabilities, known as the "funding ratio." Chicago's funding ratio hovers around 50 percent, but the condition of the pension funds managed by the state of Illinois is even worse, showing a 39 percent funding ratio, with $111 billion worth of unfunded liability.[3]

Pension Funding Ratio

CalPERS 2014

$$\frac{\text{Total Assets}}{\text{Estimated Total Liability}} = \frac{\$301 \text{ billion}}{\$394 \text{ billion}} = \text{Funding Ratio} \quad 76.3\%$$

CalPERS Annual Report 2015, https://www.calpers.ca.gov/docs/forms-publications/cafr-2015.pdf

Funding ratio calculation for CalPERS, 2014. "Total assets" is the value of the pension fund today, and "Estimated total liability" is the estimate of the future liability of the current employees whom are owed a pension. This is an estimate over several decades, so there are a lot of assumptions built in, and a great deal of uncertainty.

These are just the cases that make the headlines. In thousands of other governments across the country, pension contribution increases are a constant source of fiscal stress, resulting in cuts to schools, infrastructure, and increases in taxation. Despite the stress of added payments, the problem is not going away. America's public pension systems are, on average, only 74 percent funded as of 2014, with only $3.6 trillion in assets on hand to pay $4.8 trillion in liabilities, an unfunded liability of $1.2 trillion.[4] These governments have only a fraction of the assets on hand to make all the pension payments they have promised to their members. Retirement benefits, state and municipal budgets, and taxpayers are jeopardized. It is a crisis all around.

And yet, is it really true? A close look at the Detroit bankruptcy shows that it really had far more to do with the politics of Michigan's suburbs and the Governor Rick Snyder's feelings about the city than it did with the mathematical reality of the city finances.[5] The narrative of runaway pension obligations sinking an ailing city's finances is simply not supported by the facts, which had much more to do with a sudden loss of state support and ill-advised interest-rate swaps.[6] Long-