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## Public Pensions Cook the Books

*Some plans want to hide the truth from taxpayers.*

By [ANDREW G. BIGGS](#)

Here's a dilemma: You manage a public employee pension plan and your actuary tells you it is significantly underfunded. You don't want to raise contributions. Cutting benefits is out of the question. To be honest, you'd really rather not even admit there's a problem, lest taxpayers get upset.

What to do? For the administrators of two Montana pension plans, the answer is obvious: Get a new actuary. Or at least that's the essence of the managers' recent solicitations for actuarial services, which warn that actuaries who favor reporting the full market value of pension liabilities probably shouldn't bother applying.

Public employee pension plans are plagued by overgenerous benefits, chronic underfunding, and now trillion dollar stock-market losses. Based on their preferred accounting methods -- which discount future liabilities based on high but uncertain returns projected for investments -- these plans are underfunded nationally by around \$310 billion.

The numbers are worse using market valuation methods (the methods private-sector plans must use), which discount benefit liabilities at lower interest rates to reflect the chance that the expected returns won't be realized. Using that method, University of Chicago economists Robert Novy-Marx and Joshua Rauh calculate that, even prior to the market collapse, public pensions were actually short by nearly \$2 trillion. That's nearly \$87,000 per plan participant. With employee benefits guaranteed by law and sometimes even by state constitutions, it's likely these gargantuan shortfalls will have to be borne by unsuspecting taxpayers.

Some public pension administrators have a strategy, though: Keep taxpayers unsuspecting. The Montana Public Employees' Retirement Board and the Montana Teachers' Retirement System declare in a recent solicitation for actuarial services that "If the Primary Actuary or the Actuarial Firm supports [market valuation] for public pension plans, their proposal may be disqualified from further consideration."

Scott Miller, legal counsel of the Montana Public Employees Board, was more straightforward: "The point is we aren't interested in bringing in an actuary to pressure the board to adopt market value of liabilities theory."

While corporate pension funds are required by law to use low, risk-adjusted discount rates to calculate the market value of their liabilities, public employee pensions are not. However, financial economists are united in believing that market-based techniques for valuing private sector investments should also be applied to public pensions.

Because the power of compound interest is so strong, discounting future benefit costs using a pension plan's high expected return rather than a low riskless return can significantly reduce the plan's measured funding shortfall. But it does so only by ignoring risk. The expected return implies only the "expectation" -- meaning, at least a 50%

chance, not a guarantee -- that the plan's assets will be sufficient to meet its liabilities. But when future benefits are considered to be riskless by plan participants and have been ruled to be so by state courts, a 51% chance that the returns will actually be there when they are needed hardly constitutes full funding.

Public pension administrators argue that government plans fundamentally differ from private sector pensions, since the government cannot go out of business. Even so, the only true advantage public pensions have over private plans is the ability to raise taxes. But as the Congressional Budget Office has pointed out in 2004, "The government does not have a capacity to bear risk on its own" -- rather, government merely redistributes risk between taxpayers and beneficiaries, present and future.

Market valuation makes the costs of these potential tax increases explicit, while the public pension administrators' approach, which obscures the possibility that the investment returns won't achieve their goals, leaves taxpayers in the dark.

For these reasons, the Public Interest Committee of the American Academy of Actuaries recently stated, "it is in the public interest for retirement plans to disclose consistent measures of the economic value of plan assets and liabilities in order to provide the benefits promised by plan sponsors."

Nevertheless, the National Association of State Retirement Administrators, an umbrella group representing government employee pension funds, effectively wants other public plans to take the same low road that the two Montana plans want to take. It argues against reporting the market valuation of pension shortfalls. But the association's objections seem less against market valuation itself than against the fact that higher reported underfunding "could encourage public sector plan sponsors to abandon their traditional pension plans in lieu of defined contribution plans."

The Government Accounting Standards Board, which sets guidelines for public pension reporting, does not currently call for reporting the market value of public pension liabilities. The board announced last year a review of its position regarding market valuation but says the review may not be completed until 2013.

This is too long for state taxpayers to wait to find out how many trillions they owe.

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