[Bond Case Briefs]

Municipal Finance Law Since 1971

[Hidden Debt, Hidden Deficits: 2017 Edition.]

A new analysis by Josh Rauh at Stanford University's Hoover Institution – [Hidden Debt, Hidden Deficits: 2017 Edition] – says state and local governments' collective unfunded pension liabilities are actually about three times the amount they claim. Rauh, a finance professor who has long been a critic of public pension accounting, arrived at his figure by assigning pension plans a much lower assumed investment rate of return.

Pension plans in 2015 collectively reported about $1.3 trillion in unfunded liabilities. In other words, they have about 72 percent of the assets they need to meet their estimated total liabilities. That figure assumes plans will earn an average of 7.4 percent each year on their investments.

Rauh, pointing to the wild swings of the stock market and the fact that pensions are putting more of their assets into volatile, alternative investments, says that assumption is too risky. He argues it's more responsible to consider a rate of return closer to what long-term bonds earn: slightly less than 3 percent. Under those assumptions, Rauh says unfunded U.S. public pension liabilities would roughly triple to $3.8 trillion, or less than half-funded.

The Takeaway: Rauh is arguing for accounting responsibility. And to be sure, the underwhelming returns of pension plans over the last two years bolster his case. Several pension plans have already acknowledged that their investment return assumptions likely won't hold up in the long term and have lowered their assumed rates of return to 7 or 6.5 percent. But to drastically lower return assumptions would be devastating for governments and impair their ability to provide services to constituents.

Rauh even cites those consequences in his research. In the worst example, Illinois in 2015 put a whopping 11 percent of its own revenue into its pension plan. Even though that's a far higher share than other states, Illinois' payment was still short — it actually needed to contribute more than 16 percent. Under Rauh's approach, Illinois would have to contribute more than 23 percent of its revenue to avoid a rise in liabilities. That would dwarf education spending and make pensions second only to Medicaid as the state's highest single expense.

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