WSJ: The Hidden Danger in Public Pension Funds.

Their investments expose government budgets and taxpayers to 10 times more risk than in 1975.

The threat that public-employee pensions pose to state and local government finances is well known—witness the federal ruling earlier this month that Detroit's pension obligations are not sacrosanct in a municipal bankruptcy. Less well known is that pensions are larger and their investments riskier than at any point since public employees began unionizing in earnest nearly half a century ago.

Public pensions have long been advertised as offering generous, guaranteed benefits for public employees while collecting low and stable contributions from taxpayers. But with Detroit's bankruptcy filing, citing $3.5 billion in unfunded pension liabilities, and with four of the five largest municipal bankruptcies in U.S. history occurring in the past two years, reality tells us otherwise.

How much riskier are public pensions now? According to my research, public pensions pose roughly 10 times more risk to taxpayers and government budgets than in 1975. And while elected officials—a few Democratic mayors included—are now pushing for reforms, even they may not realize the danger.

In 1975, state and local pension assets were equal to 49% of annual government expenditures, according to my analysis of Federal Reserve data. Pension assets have nearly tripled to 143% of government outlays today. That's not because plans are better funded—today's plans are no better funded than in 1980—but mostly because pension plans have grown as public workforces have aged.

The ratio of active public employees to retirees has fallen drastically, according to the State Budget Crisis Task Force. Today it is 1.75 to 1; in 1950, it was 7 to 1. This means that a loss in pension investments has three times the impact on state and local budgets than 40 years ago.

And pensions can expect to take losses more often because of increased investment risk. Public plans have historically assumed roughly an 8% rate of return. But thanks to falling yields on safe assets, pensions must invest in riskier assets to have any hope of getting 8% returns. A one-year Treasury bond in 1975 yielded a 5.9% return. In 1980, it offered 14.8%, and in 1985 an investor could expect 6.5%. Today, the Treasury yield hovers at 0.1%.

Meager yields leave America's enterprising public-pension plan managers with a choice: Accept a lower return—forcing higher taxpayer contributions—or take on more risk to keep 8% returns flowing. My estimate, based on Treasury yields and analysis from economists at the Office of the Comptroller of the Currency, is that a pension today must build a portfolio with a standard deviation—how much returns vary from year-to-year—of 14%. Such high volatility means that a fund would suffer losses roughly one out of every four years.

By contrast, in 1975 a plan could achieve 8% expected returns with a standard deviation of just 3.7%. Those portfolios would lose money once every 65 years. This level of risk varied little through the 1980s and 1990s: An 8% return portfolio in 1985 would require a standard deviation of 2.7%, and 4.3% in 1995. Risk began inching upward after 2000 and has increased rapidly since the recession as low-risk assets continue to fall.

These figures aren't theoretical. They represent public pensions' decades-long shift from safe bonds to risky stocks, along with the recent growth of "alternative investments" such as hedge funds and private equity. These alternatives are, according to Wilshire Consulting, 60% riskier than U.S. stocks and more than five times riskier than bonds.

Larger pensions and riskier investments combine to increase risk to state and local budgets. The standard deviation of public pension investments equaled 1.8% of state and local budgets in 1975. That figure crept upward to 2.2% in 1985, and reached 5.8% in 1995. Today it stands at 19.8%. Pension investment risk to budgets has risen roughly tenfold over the past four decades.

As pension plan managers in Detroit, California and elsewhere can attest, there aren't easy solutions. Mature pensions should move their investments away from risky assets, but many plan managers are doing the opposite in a double-or-nothing attempt to dig out of multitrillion-dollar funding shortfalls. In most instances, significant benefit cuts for current retirees who made the contributions asked of them is difficult to justify and legally problematic.

The only real option, then, is to make structural changes, including more modest benefits and increased risk-sharing between plan sponsors and public employees. But that will only happen if elected officials accept that they can't continue with business as usual without accumulating tremendous risk.

By ANDREW G. BIGGS

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Mr. Biggs is a resident scholar at the American Enterprise Institute.