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States Get Creative on Pension Funding.

The latest plans in California and New Jersey have observers asking: creative solution or accounting gimmick?

Most states have enacted some type of reform over the past decade to shore up their pension funds for the future. But such changes have typically done little to make a dent in the liabilities that governments already have on the books.

As those liabilities increase, states and localities are turning to more creative solutions to ease the burden.

California and New Jersey are moving forward with plans that would boost respective pension assets, dramatically decrease unfunded liabilities and reduce payouts for the immediate future. But critics of the plans say the two states are doing nothing more than moving numbers around on paper.

In New Jersey, the state is pledging its lottery — which an outside analysis determined was valued at $13.5 billion — as an asset to state pension funds. The action would reduce the pension system's $49 billion unfunded liability and improve its funded ratio from 45 percent to about 60 percent, according to State Treasurer Ford Scudder. The roughly $1 billion in annual lottery proceeds, which currently go to education and human services, among other programs, will now be divvied up among state pension funds. The largest share — nearly 78 percent — will go to the teachers' pension fund.

Although unions grumbled about the plan, it passed with little public debate as lawmakers were preoccupied by budget negotiations. Gov. Chris Christie and Scudder have hailed the lottery legislation as a foolproof way to immediately boost the health of the pension fund. But others have been less enthusiastic about the plan.

Municipal Market Analytics' Matt Fabian dubbed it an accounting scheme, noting it also places a roughly $970 million burden on New Jersey's general fund budget to pay for the programs formerly covered by the annual lottery proceeds. "We believe that, at best," Fabian wrote, "this transaction delays honestly confronting the pension liability problem."

The move hasn't impressed credit rating agencies, either.

In recent years, they have repeatedly lowered New Jersey's rating in part because of its increasing unfunded pension liabilities. "It's not a cash infusion," says S&P Global Ratings analyst David Hitchcock. What's more, he says, the state runs the risk of assuming its assets "are better than what they really are."

The ratings agencies have a more positive view of California's proposed pension funding plan.

Developed by Gov. Jerry Brown and State Treasurer John Chiang's offices, California will borrow $6 billion from its Surplus Money Investment Fund to pay down a portion of its $59 billion unfunded pension liability. The surplus fund account typically earns less than 1 percent interest because it is invested for very short periods so that it can be quickly accessed for payment. Brown and Chiang say the money in the surplus fund could be put to better use in the state's pension fund, where it can be invested for the long-term and earn a higher interest rate.

The state is making its full pension payment this year in addition to depositing the loaned money. That will result in a nearly $12 billion boost to the fund this year. The cash infusion would immediately help lower the state's annual pension bills. California would pay back its surplus fund — plus interest — over the course of a decade.

Moody's Investors Service has called the idea a credit positive one because it "suggests the state will aggressively counter a projected rise in its unfunded pension liabilities." Some governmental organizations, such as the California Budget and Policy Center, have also offered positive reviews, comparing the move to a refinancing of debt without the risk and exposure associated with owing money to bondholders.

But David Crane, a frequent critic of Brown and a Stanford University public policy lecturer, is skeptical the $6 billion infusion into the state's pension system will generate the 7 percent annual earnings that officials project. In addition, given the recent income tax revenue shortfalls, he cautions that the surplus fund may be needed before the state has paid it back. "Circumstances change and the state's principal responsibility is to provide services," he wrote in an op-ed.

With both of these approaches, much of their success depends on how well the pension investments perform. But no matter how that plays out, more governments are likely to follow with their own creative funding solutions.

"There's always going to be a temptation when budgets are strained to look for a way to reduce pension funding," says Hitchcock. "When a government tries to do so as a gimmick as opposed to real reform or real pension funding, [it's not] seen as a positive."

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