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Can Fiscal Alchemy Bolster Public Pension Funds?

Some government employers are exploiting the peculiar rules of public finance to transfer public assets or cash from clever deals to their pension funds. But there's risk to taxpayers when it's magic beans and shell games.

The way state and local governments keep their books is uniquely different from the way the private sector operates. Public-sector organizations are expected to be "perpetuities" — to never go out of business — and to provide for a common good. So they record assets and liabilities in unique ways. The same is true for their pension funds.

Precisely because governments are viewed as perpetuities, public pensions use an "expected" rate of return on their invested assets rather than a more conservative, risk-free rate as is required of private companies. When the public plans' investment returns fall short of the expectations, as they have in many plans over the past decades, an unfunded actuarial accrued liability is the result. Public employers are expected (and in some states, obliged) to pay an annual contribution for unfunded liability on top of their normal actuarial costs.

Needless to say, the public finance community is constantly looking for clever ways to reduce these annual burdens and improve the pension funds' actuarial balance sheets. If they can find a way to pump up the assets held by the pension fund that requires lower annual costs for the employer, the hired financial professionals who collect fees for their ingenuity are rewarded for that fiscal alchemy.

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