August 27, 2012 **Policy Brief: Volume 12, Number 42**

Pittsburgh in Denial about Pension Assets

In yet another example of can kicking on a critical public policy issue, the Pittsburgh pension board voted down City Controller Lamb's proposal to study whether Pittsburgh should lower the current 8 percent rate of return on assets to 7.5 or 7 percent. The Mayor is quoted as saying that lowering the rate from 8.0 to 7.5 percent would require the City to increase payments to the pension funds by an additional $9.3 million per year over and above what it is currently contributing. Refusal to undertake a study seems extraordinarily shortsighted. A lot could be learned about the implications of the current level of unfunded liabilities and what potentially lies ahead in terms of serious difficulties for the pension plans under a scenario of continued very weak national economic growth and slow tax revenue gains at the state and local level.

As we noted in a recent *Policy Brief (*Vol. 12, No.40) state experts on pension asset evaluation have called on the City to recognize that its use of an 8 percent rate of return on assets and discounting liabilities is too high in light of recent investment performance. And even using the 8 percent rate of return/discount rate, Pittsburgh's funded ratio (assets to liabilities) is only 57 percent. Obviously the City is not alone in having pension funding problems. Note that Pennsylvania's State Employee Retirement System (SERS), which uses a 7.5 percent rate of return (and liability discount rate), currently faces a $14.7 billion shortage in assets relative to its liabilities and has a funding ratio of 65 percent. The ratio is projected to fall to 55 percent by 2015 and will require substantial increases in the Commonwealth's contribution to the plan over the next few years.

However, according to pension expert Andrew Biggs of the American Enterprise Institute Pennsylvania's problem is much worse than is being portrayed. Mr. Biggs argues in testimony given to the state legislature that if Pennsylvania were being held to the standards imposed on private sector firms the state's assets to liabilities ratio would be only 40 percent and SERS would be facing a funding shortfall of $42 billion.

Obviously, applying the private sector accounting standards to Pittsburgh would dramatically increase its pension liabilities and lower assets to produce a markedly lower funded ratio than the current 57 percent while swelling the asset shortfall enormously.

As Mr. Biggs noted in his testimony, Moody's has announced that it will begin evaluating pensions by discounting liabilities by the same rate of return being applied to assets, namely, the rate on high quality corporate bonds. Such a change is estimated to triple unfunded pension liabilities across the country.

This estimated tripling of unfunded liabilities provides some perspective on the Pittsburgh situation. Little wonder the City pension board just opted not to study lowering the 8 percent rate of return/discount rate. The City claims it can simply not afford to lower the rate at present because it would require diverting spending from other City services. If lowering the rate of return to 7.5 percent—the rate currently used by the state—would cause the City's pension payments to rise by another $9.3 million and the state's adoption of private sector pension standards would nearly triple its unfunded liabilities, it can be reasonably surmised that adopting private standards by the City would massively increase its additional annual pension payment while putting the plans on a much firmer footing. Indeed, meeting private sector standards could easily double the $9.3 million additional annual contribution requirement created by lowering the rate to 7.5 percent.

The interesting thing to watch is how the state Legislature and Governor address the gap between public pension accounting rules and private accounting standards. To date, public standards have been more lenient on the premise that if need be taxpayers can always be taxed more to meet pension payment obligations. But as we are seeing in California and other places, when tax burdens rise to unbearable levels, raising tax rates is actually self-defeating as residents and businesses leave. So it is understandable that Moody's will be adopting a stricter evaluation methodology for public pensions. The fiction that taxpayers can be forever called upon to pony up more and more to cover pensions while at the same time trying to maintain adequate core government functions is now being revealed for what it is—an illogical extrapolation based on never having encountered such widespread overpromising by municipal governments.

If the national economy does not soon recover its footing and accelerate to more traditional levels of growth experienced during an economic recovery and then sustain more normal growth, public pension plans all over the country are going to be in serious jeopardy of being massively downgraded with the accompanying requirement to put much more money into the plans. Will Pennsylvania's lawmakers punt on this or get ahead of the problem by lowering the rate of return/discount rate to be used by the state, teachers and all municipal pension plans? Or will they wait and hope for a national economic miracle to bail them out?

Here's the problem. Even if the economy strengthens and pension performance improves somewhat, the lessons just learned cry out for major reforms of pensions at both the state and local level. Defined contribution plans must be adopted for all employees not currently vested. Unions can be asked to renegotiate the generous terms of pension plans for employees not yet retired. Years of service, final income to be used as determining benefits and the percentage of income per year of service should all be on the table. The Commonwealth must also put stricter accounting standards on municipal and teacher pensions as well.

Given the size of the current and pending funding shortfalls at the state and local levels, there can be no excuse for not being better prepared when the next major economic downturn happens.

Jake Haulk, Ph.D., President

Allegheny Institute for Public Policy
305 Mt. Lebanon Blvd.* Suite 208* Pittsburgh PA 15234
Phone (412) 440-0079 * Fax (412) 440-0085
E-mail: aipp@alleghenyinstitute.org