

# Faulty Analysis is Unhelpful to State and Local Pension Sustainability Efforts

October 2010



As state and local governments lead efforts to address the unprecedented fiscal challenges created by stagnant economies, in the face of aging populations and workforces, the accuracy and integrity of information is more vital than ever. Authors of a new paper, *The Crisis in Local Government Pensions in the United States*, would be more constructive, as well as provide more accurate municipal pension information, if their assumptions were based on historical experience and their methodology appropriate for the government sector. Robert Novy-Marx and Joshua Rauh – who also earlier this year authored, *Are State Public Pensions Sustainable?* – again vastly underestimate projected future contributions to public pension plans and expected investment returns to draw dramatic and improbable conclusions regarding the solvency of these plans.<sup>1</sup> Both papers are based on pension fund assets values as of 2009, prior to the recent improvement in financial markets. Further, their method used to determine future pension liabilities of states and localities is not recognized by governmental accounting standards. The authors additionally ignore changes already underway at the state and local levels to restore long-term pension sustainability, and they make recommendations that would only serve to worsen the financial condition of these plans.

## *Assumptions of Future Behavior Are Not Supported by Past Practice*

The reports' findings are premised on two key suppositions: 1) state and local governments will contribute nothing to amortize past pension liabilities, and 2) funds will generate rates of return commensurate with highly conservative, "risk-free" all-bond portfolios, rather than the diversified portfolios actually in use. These two assumptions are inconsistent with plans' actual experience, as most governments have a history of paying their pension contributions. In fact, according to the Public Fund Survey, from FY 01 to FY 09, on average, pension plan sponsors paid 91 percent of their required contributions. Regarding investment returns, the standard assumption is that pension fund portfolios will earn a real (after inflation) return of 4.5 percent annually, based on the mix of assets they typically hold, and more reasonable given the current ratio of stock prices to trend earnings.<sup>2</sup> Further, analysis shows that public pension funds' actual long-term investment returns still exceed this assumption, even after incorporating losses from the 2008 market collapse.<sup>3</sup>

## *Projections Are Based on Asset Values Near Their Market Low Point*

The authors base their financial analysis on pension asset values as of June 30, 2009, at the end of a 12-month period when the S&P 500 had a return of -26.2%, and prior to much of the market increase that took place the following year. Pension fund asset values have been growing since March 2009, and for the year ended June 30, 2010, median public pension fund investment returns were 12.8 percent, well above plans' typical assumed investment return of eight percent. In addition, historical investment experience over 20-, 25- and 30-year time periods, a more appropriate measure of the long-term investment horizon of public funds, also exceed this assumed rate of return.<sup>4</sup>

## *The Method Used to Value Future Liabilities Is Inconsistent With Accounting Standards*

Another factor driving the authors' findings is the method used to value future pension liabilities, which is not compliant with public sector accounting standards. In fact, the Governmental Accounting Standards Board, which has been reviewing these standards over the past three years, recently affirmed its support for the use of a long-term expected rate of return, rather than the use of current interest rates. In its Preliminary Views, published last June, GASB specifically "considered but rejected" an interest rate-based method for valuing future liabilities (the approach used in the Novy-Marx-Rauh paper), stating instead that, "The rate used should be a reasonable estimate of the rate at which plan net assets are expected to grow, over a term commensurate with the accounting measurements for which the rate is used, as a result of investment earnings."

<sup>1</sup> [Based on original analysis prepared by Paul Zorn and Mita Drazilov at Gabriel, Roeder, Smith & Company, Paul Angelo at The Segal Company, and Keith Brainard at NASRA.](#)

<sup>2</sup> ["More Scare Stories About State Pensions at the NYT," Dean Baker, Center for Economic and Policy Research, June 20, 2010.](#)

<sup>3</sup> ["NASRA Issue Brief: Public Pension Plan Investment Return Assumptions," National Association of State Retirement Administrators, March 2010.](#)

<sup>4</sup> ["Investment Return Assumption for Public Funds: The Historical Record," Callan Investments Institute Research, June 2010.](#)

### ***Analysis Does Not Account for Recent State/Local Pension Changes***

More state and local governments have enacted significant modifications to their retirement plans in 2010 than in any other year in recent history.<sup>5</sup> Since 2006, nearly two-thirds of the states have made changes to benefit levels, contribution rate structures, or both<sup>6</sup> and many more local governments also have made adjustments. Ignoring these alterations results in a gross mischaracterization of the current situation and disregards the measured approach that can be and has been taken to *realistically* and responsibly close pension funding gaps.

### ***The Authors' Recommendations Do More Harm Than Good***

In response to their dire projections, the authors have suggested that state and local governments should no longer offer pensions to new hires, recommending instead that such employees be covered with Social Security and a 401(k) plan, and that states and cities should issue debt – possibly at a federally subsidized rate – to pay off the added cost of closing pension plans. These recommendations ignore the significant cost and disruption that would be imposed by such changes:

- **Mandatory Social Security Adds Billions in Expenses.** Conservative estimates of the added expense of mandating newly hired public workers into Social Security are over **\$44 billion in the first five years alone**,<sup>7</sup> which would worsen the financial condition of the sponsoring governments and their pension systems.
- **Putting New Hires Into a 401(k) Increases Costs.** Recent studies have shown that closing pensions to new hires can have several serious, unintended consequences, including increasing administrative costs associated with running two plans, forgoing or undermining economic efficiencies of traditional pension plans, accelerating pension costs for employees in the closed plan, worsening retirement insecurity, and potentially damaging employer recruitment and retention efforts.<sup>8</sup> Moreover, although 401(k)-type plans are a useful means of supplementing pension benefits, they are inherently not as effective or efficient as a primary source of retirement income. By pooling mortality and investment risks, traditional pensions reduce participants' risk of outliving retirement assets and can provide the same benefit at nearly half the cost of a defined contribution plan.<sup>9</sup> Unlike a traditional pension plan, a 401(k) does not include provisions for disability and death benefits, which are especially important for employees in hazardous occupations such as firefighters and police officers, who face higher risks in the line of duty. Without a pension, these benefits would have to be provided through commercial insurance, likely at significantly higher costs to the employer.
- **Issuing Debt and/or Asking for Federal Involvement Adds Risk.** Proposing that state and local governments should issue debt to fund their pension benefits adds risk to the funding equation. Such debt would become a liability for the sponsoring government. If the markets fall after the funds are invested, the government now has two sets of liabilities: the outstanding debt and the pension liability. Even with a federal subsidy – which is unlikely given current federal government budget constraints and which raises additional challenges – this is a risky approach.<sup>10, 11</sup>

**In the wake of the Great Recession, states and cities are examining and adjusting pension benefit levels and financing structures to restore reserves and long-term sustainability. Hyperbole and distortion, as presented in the referenced academic papers, are not helpful to these efforts or to the long-term fiscal health of state and local governments and their retirement systems.**

Contact:

Keith Brainard, NASRA Research Director [keithb@nasra.org](mailto:keithb@nasra.org) 512-868-2774

Jeannine Markoe-Raymond, NASRA Director of Federal Relations [jeannine@nasra.org](mailto:jeannine@nasra.org) 202-624-1417

---

<sup>5</sup> [“Pensions and Retirement Plan Enactments in 2010 State Legislatures,” Ronald K. Snell, National Conference of State Legislatures, October 10, 2010.](#)

<sup>6</sup> [“Pensions and Retirement Plan Enactments in 2010 State Legislatures,” Ron Snell, National Conference of State Legislatures, May 17, 2010.](#)

<sup>7</sup> [“The Cost Impact of Mandating Social Security for State and Local Governments,” Cathie Eitelberg, Alexander Sussman, F.S.A., and Leslie Thompson, Revised 2005.](#)

<sup>8</sup> [“Look Before You Leap: The Unintended Consequences of Pension Freezes,” Ilana Boivie and Beth Almeida, National Institute on Retirement Security, October 2008.](#)

<sup>9</sup> [“A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans,” Beth Almeida, William B. Forna, FSA, National Institute on Retirement Security, August 2008.](#)

<sup>10</sup> [“Evaluating the Use of Pension Obligation Bonds,” \*Government Finance Officers Association Advisory\* \(1997 and 2005\).](#)

<sup>11</sup> [“Issue Brief: Pension Obligation Bonds: Financial Crisis Exposes Risks,” Alicia H. Munnell, Thad Calabrese, Ashby Monk, and Jean-Pierre Aubry; Center for State and Local Government Excellence, January 2010.](#)