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The Real Issue for Public Pensions Is Disclosure of Liability

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Recently, state Treasurer Bill Lockyer criticized a Stanford University study about California's public pensions as "junk," asserting that "the fundamental problem is its claim that state pension funds should assume only a 4.1 percent return" on investments.

Stanford's study makes no such claim. Instead, it claims that California is not disclosing the full size of pension liabilities. Public pensions are promises to make lifetime payments to employees after retirement. Those promises are debt-like obligations, created by governments without a vote of the people, but paid by them. Stanford's study quantifies the size of those obligations.

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As anyone with a mortgage knows, the size of your debt doesn't have anything to do with the rate of return you hope to earn on your house or stocks. If you owe \$10,000, your obligation is \$10,000, and that fact doesn't change just because you hope your house or stocks will rise in value. But that's not the way states are currently allowed to report their pension liabilities. Instead, current accounting rules allow them to reduce those by the amount they hope to earn from investments. As a result, states are allowed to report a \$10,000 pension obligation as only \$5,000.

Confused? You should be. After all, the state is on the hook for pensions regardless of how investments perform. As former Federal Reserve Vice Chairman Donald Kohn puts it, state pension promises are "bulletproof promises to

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pay,” which means retirees face no risk they won’t be paid in full. Yet California reports those obligations as though retirees are owed only half as much.

The Stanford study says that California should report the full size of its pension liabilities. It’s the same conclusion reached by Northwestern, University of Chicago, Boston College, Wharton, and other academies that say that states are understating pension liabilities nationwide by trillions of dollars. California’s share is more than \$400 billion.

This is not just an academic discussion. In a sad tale reported last year by Alicia Munnell of President Clinton’s Council of Economic Advisers, in 1999, California boosted pensions after half-size accounting showed a surplus in state pension funds when full-size accounting would have shown there was a deficiency. Since then, \$25 billion has been diverted from higher education and other programs of importance to Californians to pay rising pension costs, with more to come. In other words, through the use of half-size accounting, the state reported it had no pension liabilities, yet over the last decade, the state has spent \$25 billion to meet those supposedly nonexistent liabilities. This underaccounting of liabilities is a key reason taxpayers keep getting surprised by ever-larger spending on retirement benefits.

As we learned from the financial crisis, bad accounting can lead to bad decision-making. Through less-than-full

accounting, companies such as Lehman, Bear Stearns, and AIG lured investors into an economy-risking web of transactions. Likewise, less-than-full accounting allows politicians to make budget-crushing decisions.

Lockyer will tell you, and it is true, that current accounting rules permit the state to report pension obligations the way it does now. But that was just as true of Lehman, Bear Stearns, and AIG, which also were in compliance with accounting rules that allowed them to report as they did. Also, states can disclose more than just the bare minimum. New York City’s chief actuary does that now when reporting pension liabilities. Since pension liabilities are created without voter approval but paid by them, shouldn’t Lockyer wish to err in favor of more, not less, disclosure?

As for the issue Lockyer mistakenly attributed to the Stanford study, he says it’s reasonable for California’s pension funds to assume they will earn 30 percent more on investments than markets earned in the 20th century and 15 percent more than super-investor Warren Buffett expects to earn on his pension funds. If Lockyer is wrong, you and your kids will get to pick up the difference. You be the judge.