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Rosy Assumptions Could Derail Public Pension Reform Efforts

By Gerald Cross

When Pittsburgh's city controller proposed a study to determine if a more realistic rate of return on investments for the city's troubled municipal pension fund was needed, Mayor Luke Ravenstahl flatly refused.

Noting that a lower rate of return would mean an increase in the city's required pension fund payments that could translate to the need for a property tax hike, Mr. Ravenstahl said that "to me, this is where this is going, and I'm not going to do it."

He wasn't alone. Three other pension board members, including the city council president, the firefighters' union president and the public safety director, also opposed the move, according to the 2012 Pittsburgh Post-Gazette article. As a result, City Controller Michael Lamb backed down: "I don't believe 8 percent is realistic for this kind of fund. But you're right, the other side is, can we afford to lower it?"

Buried in the debate about how to fix Pennsylvania's myriad state and municipal pension problems is the concern that many, like Pittsburgh, are even more underfunded than reported because of overly optimistic rates of return, which are the amount of earnings expected on pension investments. Pension boards often turn a blind eye to the issue because facing it would require contributing even more money to the systems at a time when fully funding the plans already seems overwhelming.

Their fears are justified. The Pennsylvania State Employees' Retirement System and Public School Employees' Retirement System added a whopping $7 billion in new liabilities when the assumed rate of return was reduced by only a fraction, from 8 to 7.5 percent. Current liability for those pension funds now stands at $14 billion for SERS and $30 billion for PSERS.

It's not unusual for government to mask inconvenient realities – like the strong possibility of getting lower earnings on investments than predicted – in order to suit an agenda, according to economist Walter J. "John" Williams, whose Shadow Statistics web site takes aim at what he believes are biased indicators for federal unemployment, the federal deficit, CPI and GDP.

"Government data are biased in politically correct directions and increasingly have diverged from common experience and reality since the mid-1980s," he says in the introduction to his web series on suspect government reporting.

Defenders of the high 7.5 to 8.5 percent rates of return commonly used by many public pensions point to yields achieved over the past 25 years as justification, according to noted Pennsylvania pension expert Richard Dreyfuss.

But Mr. Dreyfuss – unconvinced that the past is necessarily an indicator for the future – questions whether that is an appropriate rate for the next 25 years. He is especially leery given growing government deficits on both the state and federal level that he fears will divert productive capital from the private sector to the public sector.

Mr. Dreyfuss also believes that expecting a higher rate of return often translates to placing investments in more risky portfolios, a risk that is then borne by current and future taxpayers.

So what are more appropriate assumed rates of return? Mr. Dreyfuss points to reports by three respected pension administrators. A 2011 Wilshire Associates study indicated none of the 126 state retirement systems – including PSERS and SERS – will be able to meet its actuarial systems assumed rates of return over the next 10 years. The likely return is estimated at 6.5 percent. A 2012 Welton Investment Corp. study yielded a 5.69 percent expected annual return for the next seven to 10 years. And the Pennsylvania Municipal Retirement System lowered its investment assumption from 6 to 5.5 percent.

As Pennsylvania grapples with the issue of pension reform, it's clear that underlying assumptions like the rate of return must be given as much weight as modifications designed to make plans more solvent.

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