



Commentary

The Teacher Pension Nightmare

Josh Barro, 04.14.10, 11:27 AM ET

Pension and retirement plans all over America have lost value. Plans covering public school teachers, by their own admission, are underfunded by \$332 billion. However, the plans' real funding gap is far worse than their financial statements show, at nearly a trillion dollars--and you and I will bear the burden of covering their shortfall.

The story of how this happened is familiar: States expanded their promises to retirees when times were good. Then, the economy tanked, pension assets fell in value and states skirted their obligations to deposit cash in pension funds--all causing a funding gap. But because benefits are contractually guaranteed, the obligation to cover any funding shortfall lies with taxpayers.

Actuaries are telling states and localities to cough up far higher payments out of current budgets to shore up the plans. In the education sphere these obligations are putting new pressure on local taxes and competing with funding for classroom instruction.

Unfortunately, an often overlooked aspect of the pension gap story makes matters even worse: Governments use accounting methods that have consistently understated pension funding gaps in both good times and bad. Examined on a more realistic basis, the true gap in teacher pensions is nearly three times the official amount--and the taxpayers who will have to close it are in for three times the pain.

Recently, Stuart Buck and I authored a paper for the Manhattan Institute and the Foundation for Educational Choice called "Underfunded Teacher Pension Plans: It's Worse Than You Think." We reestimated the unfunded liabilities of major teacher pension plans by applying private-sector-style accounting and marking asset values to market. We found that all the plans are underfunded, and the aggregate funding gap is \$933 billion.

The key accounting problem lies in the "discounting" assumptions used by public plans. All pensions use some kind of discounting to reflect the fact that a promise to pay \$1 next year does not require \$1 in assets today. But the specific way that public pensions discount liabilities causes them to underestimate the present cost of paying future benefits.

Operating under guidance from the Government Accounting Standards Board, public plans discount future liabilities at a rate equal to their expected return on assets--which, for the 59 plans in our study, was typically close to 8%. Under this assumption \$100 assets today would be considered sufficient to cover a liability of \$108 due in one year, or \$317 due in fifteen years.

But private pension plans (overseen by the Financial Accounting Standards Board) may not set a liability discount rate based on anticipated asset performance. Instead, they use a rate that reflects the risk borne by plan retirees--that is, a low level of risk. In practice, plans use a rate based on high-quality long-term corporate bond yields, currently just above 6%.

This simple adjustment has a large effect on estimated liabilities. Moving from an 8% discount rate to a 6% rate significantly reduces the power of \$100 in assets today--to covering just \$240 in liabilities fifteen years from now. Accordingly, a lower liability discount rate means a larger funding gap between plan assets and liabilities.

There are two problems with government plans' use of a higher rate. First, assumptions about asset returns may be overly aggressive in light of recent performance. Indeed, some public pension plans, including the country's largest (the California Public Employee Retirement System) are considering a downward revision of expected returns, which would increase the estimated funding gap.

But even if asset returns are estimated accurately, the high expected return reflects the greater risk inherent in equity

investments. Because that risk is not passed on to pension beneficiaries (their benefits are guaranteed, whatever the market does) it is improper to use a liability discount rate that includes the risk premium.

Effectively, the plan sponsor (whether a private company or a government) provides insurance against underperformance of plan assets. Private plans' use of a bond-based discount rate reflects that higher equity returns are not a free lunch--the firm will be required to cough up extra cash if the assets underperform. Our adjustment applies the same admission to public plans.

So, what are the implications for school boards and state lawmakers? First, they should take a step back and realize how huge this problem is. The unfunded teacher liability of \$933 billion represents about 38% more debt on top of all outstanding state and local bonds.

And while the problem in teacher plans put unique pressure on schools, similar problems exist in all kinds of public pensions. Other reports have put the total public pension funding gap at \$2 trillion or more, approximately doubling state indebtedness. So, state legislators are in a much deeper fiscal hole than they realize.

Given these facts, states must account honestly for their debts and take steps to make sure this never happens again. In the past, state legislatures have handed out pension benefit increases that were fiscal time bombs for future legislatures. Changing discount rates would properly reflect the cost of benefits in the present, and discourage shortsighted decisions.

But most importantly, governments must move away from the defined-benefit model and shift employees to defined-contribution retirement options like 401(k) and 403(b) plans. Because these plans do not guarantee specific payouts in retirement, employers cannot be on the hook for future benefit gaps.

This shift is nearly complete in the private sector: As of March 2009, 84% of state and local government employees had access to a defined benefit plan, compared to just 21% of private employees (and 16% of nonunion private employees). But defined-contribution plans also have a significant foothold in the public sector: most public universities, where faculty have been covered by defined-contribution plans for decades.

Typically, public employee unions cling tightly to defined-benefit pensions: only a handful of states, including Michigan and Alaska, have had much success moving non-university employees to defined-contribution plans. But continuing to provide unsustainable pension benefits will mean higher taxes and lower spending on actual public services--taxpayers shouldn't have to endure that so public employees can enjoy special pension treatment.

It's time for state lawmakers to say that if 401(k) plans are good enough for everybody else, they're good enough for teachers and other public employees too. Then, states (and taxpayers) can set about filling in the \$933 billion funding gap that exists for teachers alone.

Josh Barro is the Walter B. Wriston Fellow at the Manhattan Institute for Policy Research. The report can be found [here](#).

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