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BLUE MODEL BLUES

Sleight-of-Hand in Sacramento

How has California managed to accumulate a massive pension shortfall over the last 20 years even as the stock market boomed? Through complex—and purposeful—actuarial sleight-of-hand. David Crane, a lecturer at Stanford University and former advisor to Governor Arnold Schwarzenegger, explains:

> In 1995 CalPERS reported a Funded Ratio of 96%. Over the next 20 years it earned a wonderful 7.8% compound annual rate of return. But its Funded Ratio fell to 69%. The reason: Pension liabilities grew faster, from $88 billion in 1995 to more than $430 billion in 2015. As a result, unfunded liabilities grew 25x, from $4 billion to more than $100 billion.
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> Public pension liabilities grow at super-high rates because public pension fund boards deliberately suppress their valuation when they are created, as explained here. Like a coiled spring, the more pension liabilities are suppressed when created, the harsher they snap back over time. The consequences fall hardest on young people as tax revenues go to old debts rather than new services. Every $100 billion in unfunded liability translates into $300 billion of cuts, tax increases or both.

We've previously highlighted the way pension funds conceal the extent of their troubles by assuming unrealistic rates of return. For example, most public funds today depend on earning between seven and eight percent annually, even though most experts agree that this is nearly impossible in today's era of ultra-low interest rates.

But the case of California exposes a somewhat different form of dishonesty. As Crane explains in detail elsewhere, Golden State pension officials have been distorting the funds' discount rate from the beginning. This means that they can get away with understating the "present value" of their obligations, and setting aside far less than is needed. It also means that the size of the liabilities grow at a lightning-fast rate, hammering the pensions' once-stable Funded Ratio. Public sector unions and their political allies then have cover to go back to taxpayers insisting that they have unexpectedly run out of money, and need higher tax disbursements—when in fact this was baked into the cake all along.

It's not an exaggeration to say that many pension funds—not just in California, but in states and municipalities across the country—are scarcely accounted for better than fly-by-night Ponzi schemes. Action is urgently needed from state and federal lawmakers to bring them back in line. The time bomb is ticking.

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