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News from EBRI

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New Research from EBRI:

Public Pension Plan Deficits a Source of Growing Concern

WASHINGTON—Investment losses from the current recession have significantly eroded the funding status of public pension plans, affecting entities from school districts, to local governments, to state governments, and there is growing concern that increasing deficits in public plans will force taxpayers to make up for the shortfall.

But a new analysis by the nonpartisan Employee Benefit Research Institute (EBRI) shows that, under current accounting rules, underfunded public pension plan sponsors face some perverse incentives to maintain aggressive or risky investments, and that public plan sponsors are unlikely to significantly shift toward safer but lower-return investment policies, at least in the short run. The analysis appears in the April 2009 *EBRI Notes*, available at www.ebri.org

According to the EBRI analysis, public pension funding relies on three sources: earnings from investments, employer (taxpayer) contributions, and worker contributions. Of the three, investment income typically has been the most important, especially since court rulings have limited the ability of pension plan sponsors to increase worker contributions.

Under current rules adopted by the Government Accounting Standards Board (GASB), public plan sponsors face at least two incentives to maintain aggressive investment policies:

- Actuarial funding methods project higher investment income for risky asset allocations than what is assumed under more conservative investment strategies. Without that income, plan sponsors with underfunded plans would have to make higher contributions to fund the projected shortfalls in their plans.
- Public plan sponsors that want to use a high discount rate (to minimize their pension liabilities) have an incentive to maintain high-return/high-risk asset allocation strategies; under current accounting practices, a high expected rate of return can be used to lower stated plan liabilities.

While public pension plan sponsors are unlikely to significantly shift toward safer but lower-return investment policies in the short run, as the current economic recession drags on, administrators and trustees of these plans will need to seriously consider their long-term funding status and investment strategies—especially whether there is too much risk in pension portfolios, the EBRI analysis says.

Moving to lower-return but less volatile investments would increase the stated unfunded pension liability in public pension plans and therefore require additional employer contributions. However, the EBRI analysis says this may be necessary both to address the current economic reality facing public plans and to avoid the need for even greater taxpayer-financed contributions in the future. The analysis adds that the eroded funding status of public pension plans is a source of growing concern about the size of deficits in these plans and the risk that taxpayers will have to make up the shortfall.

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