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R.I. s pension debt worse than admitted

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Rhode Island s pension crisis reminds one of Greece, now slaving under externally imposed austerity the fruits of engaging in systemic deceit.

Lavish retirement benefits, including automatic inflation adjustments, awarded to state employees have resulted in future pension obligations of $11.5 billion in today s (2010) dollars. But the state has assets worth only $6.8 billion on hand to cover these obligations, implying a funding ratio of less than 60 percent.

In addition, the state provides other post-employment benefits (OPEB) to its employees (general employees, teachers, police, judges, legislators, and so on) whose present valued obligation amounts to $8 billion. This obligation is completely unfunded that is, benefits are paid out of current revenues each year.

Adding it all up, the official measure of total pension and OPEB liabilities as of 2010 is $12.3 billion and the unfunded component is $5.5 billion.

Taking the numbers at face value, the state must make up this $5.5 billion shortfall in retiree pension and OPEB programs by increasing the share of general fund budget devoted to covering accruing pension obligations and amortization costs.

State general fund revenues amounted to $5.5 billion in 2010, of which 4.2 percent is contributed to meeting current benefit accruals and amortization costs. The state s

pension obligation amortization schedule extends to about 20 years, but OPEB obligations will remain unfunded.

Unfortunately, the reality that is most likely to unfold in the future is much worse. The accounting methods used by the actuaries amount to sugarcoating the situation. The true magnitude of the Rhode Island s pension and retiree health underfunding problem is larger by billions of dollars.

As economists have repeatedly asserted, because pension benefits are guaranteed, they should be evaluated by discounting future benefit flows using a relatively safe rate of return on the order of 3 percent per year in inflation-adjusted terms. Pension actuaries, instead, use the much higher rate of return they expect on the pension fund s assets which are usually invested in risky private equities and bonds.

This accounting treatment undervalues (ignores) the risk that the relatively fixed and certain benefit obligations would have to be paid out of additional taxpayer funds because the pension fund s asset portfolio suffers losses from a market downturn precisely when it must be drawn upon (sold) to fund benefit obligations coming due.

Discounting future benefit flows at a risk-adjusted rate of interest, however, is politically unpalatable because it results in a much higher measure of pension liabilities and increases the current funding burden on the state s budget.

In the case of Rhode Island, the state s Comprehensive Annual Financial Report for 2010 (the most recent available) specifies an expected return on pension assets of 8.25 percent. The present valued pension and retiree health liability reported earlier are calculated using that discount rate.

However, using a risk-adjusted rate of return in evaluating the pension liability, and incorporating a 2 percent annual growth rate of the retiree population, shows that the total accrued pension and health liability would be 56 percent larger or $18.7 billion instead of the official total of $12.3 billion. And the unfunded liability component would be $11.9 billion instead of the officially reported $5.5 billion.

There are other concerns, as well, regarding the level of contributions being made by Rhode Island to amortize this liability and the management of the pension fund s investment portfolio. Ongoing reform efforts are likely to affect current and future state employees, but the understatement of pension liabilities hides the size of taxpayer exposure to future pension funding shortfalls.

A thorough exploration of feasible pension reform alternatives in Rhode Island is urgently needed. Unfortunately, the underlying data on historical earnings, job tenure and other information on state pension plan participants has been kept under wraps by the authorities.

This impedes transparency and the ability of state lawmakers to analyze and draw upon new ideas on how to resolve the state s pension funding dilemma and improve the programs financial condition over time. That has to change soon if there is to be any hope of dealing with this crisis.