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Rockefeller Institute points out pension risk to taxpayers

By Rick Karlin

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Public pensions are increasingly turning to risky assets to bolster what could be unrealistic return assumptions, with the alternative being looming tax hikes that would be needed to meet their future obligations to retired public employees.

That's one of the main conclusions from The Rockefeller Institute's latest dive into public pension economics.

The problem comes down to basic math and the concept of risk vs return.

In the early 1990s, safe, conservative investments such as treasury bills generated more than 8 percent per year, which meant that pensions could at the time realistically assume that rate of return.

Since then, due to continued low interest rates, t-bills are paying less than 2 percent. Many private sector pensions have accordingly lowered their assumed rates of returns.

But public pensions continue by in large to state that they expect returns over 7 percent. To reach that goal, though they have to take more risk, investing more in stocks and hedge funds and less in t-bills or government bonds.

The trouble is, if the market dips or the hedge funds perform poorly public pension trustees then need to turn to taxpayers or make cuts in government services to make up the difference, as public sector pensions are guaranteed in most locations.

Here are some more details:

In the most recent report of the Rockefeller Institute's Pension Simulation Project, Institute researchers examined the question of how much investment risk public pension funds should take. Appropriateness of Risk-Taking by Public Pension Plans examines the rise in investment risk-taking by public pension funds, and the regulatory incentives that encourage this risk-taking. It reviews insights from academic research, which generally suggests that public pension funds should hold more of their assets in fixed-income investments and less in equities. This, they indicate, would result in lower investment risk, but a lower expected return on average. Reducing investment risk would require higher contributions from government now, but would reduce risks to pension funds and to future taxpayers.

Public pension funds invest in stocks, bonds, and other assets with the goal of accumulating sufficient funds, in combination with employer and employee contributions, to pay benefits when due. Taxpayers and other government stakeholders bear the investment risk because state and local governments backstop these funds, paying higher contributions when investment returns are below expectations, and lower contributions if returns exceed expectations. Successful investing keeps pension contributions low, but unsuccessful investing creates difficulties for pension funds, their beneficiaries, and current and future taxpayers.

The authors note that there is no golden rule defining exactly how much risk plans should take, but policymakers can take two important steps that might temper future risk-taking. First, they should explore ways to change and counter the incentives and institutions that encourage U.S. public pension funds to take risk. Second, public pension funds should ensure that they analyze and communicate the risk they are taking, in ways that can be understood not just by their boards, but by the governments that contribute to their funds, and by the public that ultimately bears the risks they take.

This is the fifth report of the Pension Simulation Project at the Rockefeller Institute of Government. In addition to the authors, Donald J. Boyd, the Rockefeller Institute's director of fiscal policy, and Yimeng Yin, programmer and research analyst, the project team includes Kathleen Tempel, researcher and project manager, and Lucy Dadayan, senior policy researcher. The project is supported by the Laura and John Arnold Foundation and The Pew Charitable Trusts.

To read the report, go to www.rockinst.org/pdf/government_finance/2017-02-01-Risk_Taking_Appropriateness.pdf.