

Policy Highlighter

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Washington's pension losses will cost taxpayers, squeeze state and local governments

The value of Washington state pension funds has declined 27.5 percent since December 2007 (an \$18.1 billion loss). The loss puts the state into contention with New York, California and a few other faltering plans for the biggest loser.

Defined-Benefit Pension Market Values

December 2007: [\\$65,814,366,558](#)

May 2009: [\\$47,689,876,030](#)

17-month loss: \$18,124,490,528

Source: State Investment Board Monthly Financial Reports

The loss amounts to approximately \$30,400 for each of the plan's more than 596,000 active, inactive and retired members.

On top of market losses, Washington's pensions took another hit when the Legislature decided to suspend the minimum contribution rates, thereby reducing the funding to the pension system by \$1.17 billion for the current biennium. The decision was made despite declining pension fund values and a growing \$5.7 billion unfunded liability. It will ultimately cost taxpayers an extra \$2.5 billion through 2034.

Pension model broken

Washington is not alone in its pension woes. According to Wilshire Associates, three-fifths of state-government pension funds owe at least 20 percent more money than they have. The gap is worsening as asset values decline and liabilities increase.

States and localities have boxed themselves in by promising state workers a guaranteed retirement outcome (defined benefit plan),

Quick Summary

- *Washington state pension values have declined 27.5 percent since December 2007.*
- *The Legislature aggravated the problem by suspending minimum contribution rates and ignoring the State Actuary's recommended mortality assumptions.*
- *Washington's losses could prove to be worse than current estimates due to the pension system's abnormally high exposure to illiquid private equity.*



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rather than contributing to individual accounts that depend on investment returns (defined contribution plan). Most private sector companies did away with traditional pension plans years ago, after realizing that there was no way to guarantee an outcome 30, 40 or 50 years down the road. Rather than acknowledging this reality, elected officials have shunned it and continued to make promises that will have to be fulfilled long after they've left office.

An argument could be made that traditional pensions are better at leveling investment and longevity risk for individual retirees. For example, if a person lived to be 95 or retired in a year when the market crashed, that was okay because risks were shared with people who failed to live as long or retired in other years. But the truth of this assessment is outweighed by political realities.

Defined benefit plans rely on many suspect assumptions related to the annual rate of return on investments, lifespan length and annual contributions by the employer. A change in any one of these categories can have devastating effects on the value of a pension fund. The consequence is that taxpayers are on the hook for results that are far less than certain. Higher taxes will be necessary for state and local governments to fulfill their promises. Or, worst-case scenario, some governments may be forced into an expensive pay-as-you-go scenario, which means less cash available for general government uses.

In Washington's case, budget realities combined with political preferences to produce a perfect storm for the coming pension disaster. Legislators skipped payments to the state's pension fund for the fiscal years ending in 2003, 2004 and 2005. They also chose to ignore the State Actuary's recommendation that the state recognize longer lifespans for state employees (after all, it matters substantially whether

one assumes a 72 or a 76-year lifespan). These two mistakes were purposeful—a conscious decision by those in charge that the money was needed elsewhere.

Even if legislators had not skipped payments and had adopted more realistic lifespan assumptions, it is still doubtful they could have averted the coming pension crisis. The serious market downturn has reduced the average rate of return for Washington's pension fund for the past 10 years to 5.4 percent. The state's contribution formula assumed an 8 percent return on investments.

Washington's doubling down contributed to losses

Washington hasn't always been the biggest loser when it comes to pension funds. In fact, prior to the economic downturn the state was the envy of most public pension systems. According to Wilshire Associates, its five-year annual return of 14 percent placed it in the top two percent of its peer group as of June 30, 2007. One- and three-year returns of 21.4 and 17 percent, respectively, were in the top one percent during the same period.

The Washington State Investment Board was considered a “daring, cutting-edge investor,” according to Institutional Investor Magazine, because of its decision to risk more of its pension portfolio on private equity than any other major state plan.

In 2007, the private equity market began to falter, and \$154 billion worth of leveraged buyouts were pulled. Private equity investors were warned they could expect lower returns. Despite these facts, the board's trustees voted to increase the state's private equity allocation from 17 percent to 25 percent—significantly outpacing the next-most-aggressive state funds in Oregon and Pennsylvania, at 14 percent.

Wilshire Associates reports that across all 125 state pension plans in 2008, the average private equity asset allocation was 5.6 percent. Washington's 25 percent allocation is more characteristic of an endowment fund than a pension fund.

The state's private equity losses could prove to be worse than what is shown on paper because they are illiquid—meaning they are traded infrequently and values are hard to establish. In December 2008, the investment board's then Executive Director Joe Dear said in an interview that “private equity is valued on a lag basis, so we haven't begun to see the real effects of the downturn in the private equity portfolio.”

The investment board's website notes that “[private equity] risks and illiquidity are compensated for by a higher expected return.” But when dealing with taxpayer money and legally binding promises, taking high risks in hopes of higher returns is eclipsed by the potential for higher losses. Public sector losses are not absorbed by those who took the risks; rather, they are subsidized by taxpayers.

The board's 2007 decision to gamble a good portion of state employees' pension funds in hopes of even higher returns appears characteristic of a time when banks over-extended themselves with sub-prime loans and consumers bought homes they couldn't afford. One could hardly consider the board's choice to be “prudent,” despite the word's inclusion in its mission.

Conclusion

Ultimately, pension plans are prone to political promises that are unrealistic and unaffordable for taxpayers. Legislators must stop putting taxpayers on the hook for results that are far less than certain. To make retirement benefits sustainable over the long-run, the legislature should consider the following policy changes:

- 1) Stop the fiscal hemorrhaging by closing defined-benefit plans and replacing them with defined-contribution plans for new employees;
- 2) Raise the retirement age for state employees;
- 3) Increase payroll contributions for existing employees until employers and employees equally share normal cost.

In the meantime, the Legislature should hold oversight hearings on the State Investment Board and, with the help of investment professionals, work toward developing a comprehensive, binding pension funding model that ensures the board lives up to its mission of prudent investment.

