California state pension funds going broke, study finds

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(PhysOrg.com) -- California public employee pension systems are worse off than anyone previously projected, according to a new report generated by five graduate students in Stanford's Graduate Public Policy Program. The result could be greater pressure on the state budget and a shortage of pension funds in the future.

"This is a really dire situation," graduate student Howard Bornstein said today at a press conference at the Stanford Institute for Economic Policy Research, which is publishing the students' findings. "If we don't do something now, we're going to have major issues in just a few years."

Bornstein and his fellow graduate students examined public records of past performance of three pension funds - the California Public Employee's Retirement System (CalPERS), the California State Teachers' Retirement System (CalSTRS), and the University of California Retirement System (UCRS), which together administer pensions for approximately 2.6 million Californians.

The students ran computer simulations to predict the unfunded liabilities of the pension funds over the next 16 years.

Major investment needed

"The simulation shows that the state would need to invest more than $200 billion, and possibly as much as $350 billion, today to return the fund to a minimum responsible level of funding," said Bornstein, who noted that the figure is approximately four times the current state budget.

"It's an enormous number," said Joe Nation, a public policy lecturer at SIEPR and the advisor for the research team. He said it's important to look at the shortfall relative to state resources. Pension funds fluctuate with market performance, but state employees are guaranteed a fixed pension regardless. If the market performs poorly, the state is obligated to step in and provide the missing pension funds. That takes money away from other public projects, such as education and healthcare, Nation said.

"The students did an amazing job providing a better sense of unfunded liability for those three pension funds, and I hope observers out there will begin to understand that this is a financial train wreck that is not very far down the tracks," Nation said.

In the report, Bornstein and his fellow graduate students suggest policies to fix the shortfall and prevent a similar one in the future.

They propose that the managers of the pension funds project more realistic rates of return, which would indicate higher liabilities in the future.

"The whole approach that the state currently uses is inherently flawed. They look at averages as opposed to a fan of outcomes," said Bornstein. "If you instead look at the range of outcomes in the future, you'd see there's over a 60 percent chance of a deficit greater than $250 billion for CalPERS alone. This is something that really scares us."

The students suggest that the minimum level of caution should be for the funds to aim for an 80-percent probability of having at least 80 percent of the funds necessary to cover the pensions. They also advocate investing more conservatively, taking fewer risks.

"Funds in other parts of the country are in similar situations, and they are beginning to invest in riskier assets," Nation said. "That's exactly the wrong thing to do. If the market doesn't perform well, the taxpayer ends up paying."

Suggested fixes

The students suggest either reducing pension benefits or moving to a hybrid system in which retirees receive a smaller fixed pension combined with a 401(k)-style plan. This would relieve some of the burden on the state and give employees more responsibility for their retirement. Two-thirds of Californians would support such a plan, according to a poll by the Public Policy Institute of California.

"The biggest challenge with this is making sure elected officials understand the severity of the problem," Nation said. "It's a political hot potato and most politicians shy away from the issue because you offend a lot of the constituencies by acknowledging the problem exists."

But, he said, citizens and institutions are increasingly aware of the situation and are speaking out.

"The University of California is engaged in this debate because they finally understand that as pension fund benefits grow, there will be fewer dollars for higher education," Nation said.

The report was prepared for the Office of Gov. Arnold Schwarzenegger as part of the graduate Practicum in Public Policy, a two-quarter sequence required for master's degree students in the Public Policy and International Policy Studies programs.

SIEPR conducts research on important economic policy issues facing the United States and other countries. SIEPR's goal is to inform policy makers and to influence their decisions with long-term policy solutions.

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