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Public Pensions: Averting New York's Looming Tax Catastrophe

"I have a special word for my fellow Democrats: one cannot both be a progressive and be opposed to pension reform. The math is irrefutable that the losers from excessive and unfunded pensions are precisely the programs progressive Democrats tend to applaud."

- David Crane, California pension advisor

"There are lots of people who would like to think that because times have changed someone else will be paying for this problem. There is no one left to pay for this problem. We have got to fix it ourselves, and everyone has to make a contribution to it."

- Chris Christie, Governor of New Jersey

"Why use an 8% assumption? Because if you used more conservative numbers, as the academic studies suggest, you would have to make larger current contributions to the pensions, when state and local governments and schools are already in fiscal trouble…This is going to end in tears for many states and municipalities. I mean real tears. Pension funding in some states will be required by law to consume 25-30% or more of tax revenues. That is going to mean much higher taxes or reduced services."

- John Mauldin, president of the investment advisory firm Millennium Wave Advisors, LLC.

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I. Executive Summary

This paper examines the looming public pension catastrophe approaching our nation generally and New York State specifically. There are several key points we will consider in detail:

- The coming public pension crisis is the largest financial problem our nation faces at the state level, and the cost to taxpayers will dwarf that from TARP, the Fannie Mae/Freddie Mac bailout, the S&L bailout or any other recent American financial crisis.
  - The magnitude and nature of the pension crisis is disguised by the application of lax government accounting standards that allow for accounting deceptions and do not stand up to private sector scrutiny.
- An honest accounting of pension assets and liabilities would reveal a substantial underfunding in New York State's Common Retirement Fund of anywhere from $30 billion to $80 billion.
  - The current New York State Comptroller's pension borrowing legislation will further increase the level of underfunding.
- Under the current Comptroller, the Fund's investment returns have been significantly below the median of other comparable public pension funds for the last year, the last two years and the last three years and have thus further exacerbated New York's pension shortfall.
  - The Fund's cumulative underperformance, relative to its 8% target investment return over the past 3 years, totals nearly $50 billion.
- Pension promises to state and local government workers and retirees are guaranteed by law, legal precedent or, in some cases like New York, state constitutions.[1] Ultimately, these shortfalls are borne by unsuspecting taxpayers who are on the hook for higher taxes.
- In dealing with New York's pension underfunding, the State and its leadership must adhere to three bedrock principles:
  - The true extent of our shortfall must be made clear through an honest accounting.
  - New Yorkers are already the most heavily taxed people in the nation and cannot afford additional taxes, so increased taxes cannot be a part of any solution
  - The benefits of New York's government workers, retirees and their beneficiaries are to be provided for in full. They have earned these benefits as part of their negotiated compensation on the basis of a contract that must be honored.

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[1] For details by state, see Morrison and Foerster LLP and Greenebaum Doll and McDonald PLLC, "Index by States: Extent of Protection of Pension Interests." 25 Sept. 2007. Available at <http://finance.ky.gov/NR/rdonlyres/275A2978-5DDE-4138-A7F5-AF02D17D7F97/0/Statebystatememo10.pdf>

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While the pension crisis is national in scope, it affects each public fund individually, and we New Yorkers need to fix our own Pension Fund in order to save New York members, retirees, beneficiaries and taxpayers from this looming tax crisis. The New York State Comptroller, as the sole trustee of the State's Fund, should work with the Governor, the Legislature and all stakeholders within the framework of the principles above to develop long-term reforms that ease our Pension System back to solvency. But we cannot determine the full set of solutions that are available to New York until we first uncover the true magnitude of our own crisis. This white paper aims to uncover as much as can be determined through publicly-available sources—the Comptroller must release more data on his assumptions to allow for more fulsome analysis and, more importantly, solutions.

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II. Introduction: Why Is This A Critically Important Issue Facing Our State And Our Nation?

By any reasonable metric, the underfunding of public pension plans is the greatest state-level financial crisis facing our nation. Yet, despite its size, it remains an arcane subject, shrouded in accounting considerations that lead to misunderstandings and neglect. When faced with a potentially overwhelming subject that poses significant danger, however, the correct response should not be to bury our heads in the sand, but rather to work hard to articulate the core issues clearly and develop public support for good and lasting reform. As the nation's financial capital, New York should be a natural leader in this cause.

Unfortunately, the damage done by years of neglect has left an enormous hole in our State's Pension Fund that will take years to repair. By some estimates, State and local government contributions to New York's Pension System (which are funded through state and local taxes) will triple in the next three years;[2] and given the reported assumptions, there is cause to believe that amount will prove, in time, to be understated. For this reason, among others, we often argue that New York is in "the early stages of a massive fiscal crisis." As bad as our current circumstances are, they will get worse in the coming years. Yet, this crisis remains largely invisible, due to the cloaking effect of single-year budgeting and politicians who refuse to address the crisis they created, especially in an election year.

We must not let career politicians drive the State into fiscal insolvency. Historically, New York was the economic engine of America, a beacon of opportunity to millions of immigrants, and it can be again, if we confront our fiscal problems forthrightly and work hard to fix them before they drown us in an ocean of debt and taxes.

This report builds on our last white paper, which discussed a sweeping set of ethics reforms that we would introduce early next year. [3] Those ethics reforms would clean up our Pension Fund's management and are both necessary and interconnected to the changes we propose here. Our larger aim, through the ideas encapsulated in both papers, is to professionalize the management of the Pension Fund and break the link between our retirement system and politicians who betray the public trust, either ethically or in their failure to fulfill their fiduciary responsibilities.

[2] Gershman, Jacob. "Cuomo, Lazio Spar Over Pensions". *The Wall Street Journal*. 7 Jul. 2010. 6 Aug. 2010. http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748704862404575351420074469874.html

[3] Our ethics reform white paper can be accessed on our website. Taxpayers for Wilson. "The Office of the State Comptroller—It's a Question of Ethics." 7 July 2010. 24 Aug. 2010. <http://wilsonfornewyork.com/images/uploads/Ethics_White_Paper_Final.pdf>

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We welcome a dialogue on these issues—with political leaders, union leaders, government employees and beneficiaries, the media and certainly the taxpayers, who are being handed the bill. It is not too late to fix our Pension System and avert the fate of other failed states, but it soon will be, and the sooner we work to address our broken retirement system, the less painful it will be.

One final but important note: sadly, the whole pension debate has devolved into a food fight between fiscally responsible individuals and organizations, on the one hand, and public employees and their union leadership on the other. In our view, that is not the right fight. We do not blame public employees or their union leadership for wanting better compensation and benefits. Benefits, including future pension payments, are a negotiated part of overall compensation that have been promised under a contract and earned. Enhanced compensation and benefits are a natural goal for any employee or any organization advocating on behalf of employees. Rather, **we believe the blame lies squarely at the feet of career politicians who use taxpayer dollars to make promises we can't afford to secure campaign donations, votes and support.** Our elected officials are the ones charged with watching out for the taxpayers, and they have let their own narrow self-interest trump their broader fiduciary duties. As Arthur Levitt, Jr., argued in 2007, "If politicians aren't willing to pay for their promises, then they shouldn't make these hollow promises in the first place."[4]

The State Comptroller is the elected official with the clear fiduciary responsibility to address New York's pension problems. That is why one of our goals in transforming this office is to help reestablish a healthy, sustainable balance that provides fairly for public employees at a cost that is manageable for taxpayers. This dynamic is in the best long-term interests of taxpayers AND public employees. The crisis we would otherwise suffer could only end badly for both.

[4] Levitt Jr., Arthur. "Remarks." New York Private Equity Conference. New York, NY. 30 Oct. 2007. 24 Aug. 2010. 2 <www.pebc.ca.gov/images/files/071113_Pension.pdf>

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III. How Bad Can It Be, And How Did We Get Here?

The value of pension promises already made by U.S. state governments will grow to $7.9 trillion by 2023.[5] A series of studies suggest that the underfunding of these promises could total $3 trillion or more.[6] For most states, pension promises are guaranteed to their beneficiaries by law, legal precedent or the state constitution and are effectively the equivalent of debt that is at least pari passu with, and arguably senior to, every other State obligation. [7] No matter what, taxpayers are on the hook for them. In the event of defaults, pension underfundings would require extraordinary action in the form of large tax increases, significant debt offerings (if they could even be completed), a federal bailout or a full-blown restructuring on an unprecedented scale.

To put the $3 trillion underfunding in perspective, the cost to taxpayers for the savings and loan crisis was $124.6 billion.[8] The estimated cost to taxpayers for the Troubled Asset Relief Program (TARP) ranges from $109 to $127 billion, according to the Congressional Budget Office and the Office of Management and Budget, respectively.[9] The bailouts of Fannie Mae and Freddie Mac are projected to be $389 billion over the life of the program.[10] Those figures, as large as they are, pale next to the gathering storm of America's underfunded public pensions.

And, as with previous crises, the writing is on the wall. Yet, virtually all policymakers either choose to passively ignore the underlying reality, since the crisis is not immediate, or actively obscure it, taking advantage of lax government accounting standards to hide the truth from view.

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[5] Novy-Marx, Robert and Joshua Rauh. "The Intergenerational Transfer of Public Pension Promises," National Bureau of Economic Research, Working Paper 14343 (September 2008): 7.

[6] See the following: Aubry, Jean-Pierre, Munnell, Alicia H. and Quinby, Laura, "The Funding of State and Local Pensions: 2009-2013," Center for Retirement Research at Boston College, April 2010; Novy-Marx, Robert and Rauh. Joshua, "Public Pension Promises: How Big are They and What are They Worth?," Center for Retirement Research at Boston College, July 2010; Biggs, Andrew. "An Options Pricing Method for Calculating the Market Value of Public Sector Liabilities," American Enterprise Institute, Working Paper #164, March 2010; Novy-Marx, Robert and Rauh, Joshua, "The Intergenerational Transfer of Public Pension Promises," National Bureau of Economic Research, Cambridge, September 2008; Barro, Josh and Buck, Stuart, "Underfunded Teacher Pension Plans: It's Worse Than You Think", Manhattan Institute Civic Report No. 61, April 2010; and Novy-Marx, Robert and Rauh. Joshua, "The Liabilities and Risks of State-Sponsored Pension Plans," Journal of Economic Perspectives, Vol. 23, No. 4, Fall 2009, p. 191-210.

[7] For details by state, see Morrison and Foerster LLP and Greenebaum Doll and McDonald PLLC, "Index by States: Extent of Protection of Pension Interests." September 25, 2007, available at <http://finance.ky.gov/NR/rdonlyres/275A2978-5DDE-4138-A7F5-AF02D17D7F97/0/Statebystatememo10.pdf>

[8] United States General Accounting Office. *Financial Audit: Resolution Trust Corporation's 1995 and 1994 Financial Statements*. Washington: GPO, 1996. Print. 13. <http://www.gao.gov/archive/1996/ai96123.pdf>

[9] ---. Congressional Budget Office. *Report on the Troubled Asset Program*. Washington: GPO, 2010. Print.

[10] ---. Budget Office. *CBO's Budgetary Treatment of Fannie Mae and Freddie Mac Background Paper.* Washington: GPO, 2010. 9 <http://www.cbo.gov/ftpdocs/108xx/doc10878/01-13-FannieFreddie.pdf>

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Unfortunately, willful ignorance and deception serve only to make the issue even more pernicious and all the more important to examine in the open.

New York is by no means alone. On the contrary, New York's practice of passing fund underperformance through to taxpayers (while helping create the nation's highest state and local tax burden) has led to a smaller hole than in many states. Here, however, we are reminded of the story of a shipwreck. In the accident, 50 passengers are left treading water in the open sea while vainly waiting for help. These passengers have familiar names: California, Illinois, New Jersey and, of course, New York. It doesn't matter whether one of these passengers is a stronger swimmer than a handful of the others; if help doesn't arrive soon, they all drown, some sooner than others. The lesson here is that we should not take solace in the travails of other states—we have to right our own ship before we drown in an ocean of taxes and debt.

Root Causes

The root cause of the crisis rests with the elected officials who overpromised public benefits in order to secure political support from public employee unions. These benefits come due in the future, and the next election is always imminent; it is no wonder, then, why politicians often ignore the consequences of these promises.

In this way, politicians are to public pensions as lax underwriting standards were to the mortgage crisis—the great enablers, pursuing short-term gain at a huge long-term cost.

Had intervention in the mortgage sector occurred earlier, the ultimate fallout and cost would have been mitigated, perhaps even avoided. Unfortunately, no one wanted to pull away that punch bowl until it was too late. Similarly, very few of our elected leaders want to admit to our public pension crisis.

We could extend the analogy: the Greek sovereign debt crisis was caused by politicians who hid the size of deficits in order to muddle through what they thought were short-term troubles; the 2008-2009 banking crisis was caused by banking leaders who took on excessive leverage to magnify near-term profits with insufficient regard for the risks and attendant long-term costs. And so on….

Have we not learned anything from these mistakes? Are our public leaders so blind to these examples as to let them be repeated over and over? Without immediate action, the answer appears to be yes. This is all the more reason to bring fresh perspectives into the public sector, from individuals with the skill set and determination to identify, describe and avert financial crises before they occur.

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There's Plenty Of Blame To Go Around:

There are several groups that have aided and abetted politicians in Albany, Sacramento, Trenton and elsewhere in creating this crisis.

First and foremost on the list is the Governmental Accounting Standards Board (GASB), the agency that sets accounting standards for public pension funds. Their guidelines, so different from the policies that govern the private sector, have allowed politicians to claim for their states and municipalities far better fiscal health than would otherwise be the case under any reasonable standards. Meanwhile, GASB is funded in large part by the very public pension funds it is supposed to police. Further, GASB has roughly one-quarter the staffing of its corporate cousin, FASB, increasing its challenges. Finally, a majority of its board consists of sitting public officeholders and public financial officials, again raising concerns about potential conflicts of interest.

The actuaries who support aggressive accounting policies also bear their share of the blame. Recall that Arthur Anderson was a major accounting firm until it was revealed that their lax oversight enabled Enron's fraudulent accounting, ultimately leading to the indictment of Arthur Anderson and its dissolution. In an apt public sector example of similarly inept accounting work, a New York State actuary report in 2008 held that an early retirement bill carried no additional costs for municipalities. New York City protested the bill would cost $200 million each year, and it later came to light that the State actuary was paid for the report by public sector unions.[11] On top of that, a later report found this same actuary had vetted more than 50 bills, and a survey of just 11 of them that passed showed they would result in $500 million in eventual costs.[12] Today's pension actuaries would do well to heed the lessons of Arthur Anderson.

Various independent groups, including the Pew Center for the States, have also unwittingly served to enable select politicians. The Pew Center issued a widely disseminated report on the health of public pension funds, and New York State officials cite Pew's rankings as definitive evidence of our pensions' health. Yet, the report indicates the rankings are based on states' self-reported financial statements.[13] Pew is explicitly saying that, in the end, it has compiled information reported to it, rather than validating all of the underlying assumptions. However,

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[11] Hakim, Danny. "Unions Bankrolled Analyst Vetting Pension Bill." *The New York Times*. 16 May 2008. 24 Aug. 2010. <http://www.nytimes.com/2008/05/16/nyregion/16actuary.html>

[12] Hakim, Danny. "Pension Costs Off by $500 Million, City Finds." *The New York Times.* 3 June 2008. 31 Aug. 2010. <http://www.nytimes.com/2008/06/03/nyregion/03actuary.html>

[13] The Pew Center on the States. "The Trillion Dollar Gap." February 2010, pp. 52-54 <http://downloads.pewcenteronthestates.org/The_Trillion_Dollar_Gap_final.pdf>

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because of how it is being used by certain politicians, the Pew Report is unintentionally validating the very practices at the core of our pension problems.

Finally, national politicians have enabled their counterparts at the state level. The Tower Amendment, a 1975 amendment to the Securities Exchange Act of 1934 that creates a carveout from the disclosure requirement for municipal issuers, removed an important enforcement mechanism. With only the later creation of an insufficiently vigilant GASB, there is a void in oversight of public pension funds' financial practices that leave taxpayers unacceptably exposed.

A National and Nonpartisan Issue That Requires Local Solutions

Leading members of both parties (at least outside of Albany) recognize the size and immediacy of the pension crisis. It affects every state and public pension plan to one degree or another. The resulting costs are increasingly eating up larger percentages of annual municipal budgets nationwide at the expense of all other government services—and the resulting tax burden crowds out opportunity and jobs.

In San Diego, thanks to a history of unfunded pension deals, the City has been forced to allocate 8% of its budget to its Employees Retirement System.[14] In Los Angeles, pension costs are expected to consume 19% of their general fund budget in the coming fiscal year.[15] California pension advisor David Crane made the following point in a hearing on May 10, 2010:

> I have a special word for my fellow Democrats: one cannot both be a progressive and be opposed to pension reform. The math is irrefutable that the losers from excessive and unfunded pensions are precisely the programs progressive Democrats tend to applaud. Those programs are being driven out of existence by rising pension costs.[16]

This bipartisan problem is a zero sum game, as Democratic San Francisco Mayor Gavin Newsom also pointed out:

[14] Lowenstein, Roger. "The End of Pensions." *The New York Times*. 30 Oct. 2005. 24 Aug. 2010. <http://www.nytimes.com/2005/10/30/magazine/30pensions.html?pagewanted=print>

[15] Halper Evan and Lifsher Marc. "Public Employee Pensions Under Pressure." *Los Angeles Times.* 23 Apr. 2010. 24 Aug. 2010. <http://articles.latimes.com/2010/apr/23/business/la-fi-pension-reform-20100423/2>

[16] David Crane's testimony before the Senate Public Employees and Retirement Committee on pension reform, SB 919 on May 12, 2010. Available at <http://www.foxandhoundsdaily.com/blog/david-crane/6918-cranes-testimony-pension-reform>.

> I don't know about a more important progressive issue than pension reform. There is no discretion left in our budgets to advance our progressive values of investing in people if that discretion is taken up to meet our (pension) obligations…[17]

State or local governments in Illinois, Ohio, West Virginia and elsewhere face similar budget strains aggravated by pension promises. In Maine, there is not enough money to do much of anything else if the State adheres to its rule requiring full funding of its ballooning pension costs.[18] In New Jersey, the State opted not to contribute anything to the Police and Firemen's Retirement System in 2001 through 2003 after their pension assets plummeted in the dot-com bust. That bill is coming due; as of June 2009, New Jersey's pension systems faced unfunded liabilities of $46 billion,[19] and New Jersey became the first state to be charged by the SEC with securities fraud for its inadequate disclosure of these problems.[20]

In short, this is a national problem of towering proportions that must be addressed on a state by state basis. For every year where we refuse to acknowledge economic realities, they grow worse.

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[17] Borenstein, Daniel. "Bipartisan Pandering on Pensions." *Contra Costa Times* 22 May 2010.

[18] Walsh, Mary Williams. "Facing Pension woes, Maine Looks to Social Security." *The New York Times*, 20 Jul. 2010. 24 Aug. 2010. <http://www.nytimes.com/2010/07/21/business/economy/21states.html?_r=1&pagewanted=2>. Referring to the rule, Maine State Senator Peter Mills put the matter delicately: "It's going to rip the guts out of our budget."

[19] Dopp, Terrence. "N.J. May Forgo 2012 Pension Payment, Christie Says." *Bloomberg Businessweek*. 30 Jul. 2010. 24 Aug. 2010. <http://www.businessweek.com/news/2010-07-30/n-j-may-forgo-2012-pension-payment-christie-says.html> (Note: this assumes an annual 8.25% return on investments, an actuarial assumption that understates the magnitude of the shortfall.)

[20] United States of America Before the Securities and Exchange Commission. Securities Act of 1933, Release No. 9135, August 18, 2010, Administrative Proceeding, File No. 3-14009, In the Matter of: State of New Jersey, Respondent.

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IV. Brief Primer On the New York State Pension System

The objective of New York State's Pension System is to deliver on its constitutional commitments to pensioners at a predictable and affordable cost to taxpayers.[21] It is formally named the "Common Retirement Fund" and interchangeably referred to as "the Fund," "the System" or "the Retirement System." It is made up of two different systems: the Police and Fire Retirement System (PFRS) with 65,585 members, retirees and beneficiaries and the much larger Employees' Retirement System (ERS) with 969,845 members, retirees and beneficiaries. Together, they comprise the Common Retirement Fund (CRF) and hold assets for more than one million employees and retirees from the State government and participating local governments.[22]

CRF is the nation's third largest public pension in assets. Like all public plans, its funding sources are annual earnings on its assets (invested in a portfolio of stocks, bonds and other investments), as well as annual government employee and employer contributions.

Defined Benefit Plans And Its Implications:

New York State offers government employees a "defined benefit plan," wherein the State guarantees workers' annual payments for life upon retirement irrespective of how the plan's investments have performed.[23] From the beneficiaries' standpoint, this offers security: workers receive a guaranteed income as long as they live.[24] Promises of future payment are, by definition, fixed obligations, so anytime New York contracts with employees, the resulting future pension payments become liabilities of the State.

There is nothing inherently wrong with defined benefit plans. However, they pose two central challenges that, in the hands of profligate politicians, have proved extraordinarily costly:

- By design, defined benefit plans place market risk in the hands of the plan sponsor—in this case, New York State and its taxpayers. This stands in contrast to a defined contribution plan, where market risk (and also opportunity) resides with the individual. This, also, is not necessarily problematic—except politicians play the game of heads I win, tails the taxpayers lose. When times are flush, politicians have routinely sweetened

[21] From the standpoint of beneficiaries, this means annual annuity payments upon their retirement.
[22] Office of the State Comptroller, New York State and Local Retirement System. "Snapshot of the New York State Common Retirement Fund." 4 Aug. 2010. <www.osc.state.ny.us/pension/snapshot.htm>
[23] Novy-Marx, Robert and Rauh, Joshua D. "The Liabilities and Risks of State-Sponsored Pension Plans." *Journal of Economic Perspectives,* Vol. 23, No. 4, (2009): 191.
[24] Because the employer is committed to paying and maintaining a certain level of benefits, this arrangement is called a "defined benefit" plan.

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benefits; however, when times are challenging, promised benefits cannot be taken back. Taxpayers are stuck with the obligations.

- That dynamic brings us to the second challenge. Politicians are generally ill-equipped to assess the true costs of these programs—long-term liabilities, market risk, etc.—and thus tend to underestimate them, since it is in their interest to do so. By underestimating these costs, they can promise more; when the bill comes due, they likely won't be around to worry about it.

Here is a simple example to illustrate the importance of estimating future costs properly. Say you need to pay someone $10,000 in ten years, and you want to set aside enough cash today to make good on your promise. How much should you set aside? Well, you have to convert that future obligation (in ten years) to a present value—how much it is worth today. The rate at which you discount, or reduce, that future obligation each year is the discount rate. If you use an 8% discount rate, that $10,000 future value is only $4,632 in today's dollars. However, if you instead use a 5% discount rate, you would have to set aside $6,139 today.

The importance of this assumption can't be overstated. What if you set aside $4,632 and only achieve 5%? You end up with $7,545, a shortfall of nearly 25%. The bottom line is clear: when estimating long-term financial costs, the assumptions are critical.

Virtually all financial practitioners and economists argue that the chosen discount rate should be a function of the risk of the underlying obligation: if you have to pay the obligation, no matter what, you should use a lower discount rate to reflect the incontrovertibility of the obligation. The alternative is what New Yorkers have witnessed in this decade—applying a discount rate of 8%, achieving 5% returns and creating a significant shortfall that triggers huge tax increases.

Unfortunately, these points are lost on the vast majority of our elected leaders, most of whom lack the training or experience to adequately consider the hugely consequential impact of discount rates on public policy. For evidence, one needs to look no further than New York State's Pension Fund, which uses an outsized 8% discount rate (although in the face of increasing criticism from us and others, the Comptroller is said to be considering a marginal reduction).[25] To apply the analogy used above, since the Pension Fund has been using an 8% discount rate but has achieved returns of less than 5% over the last decade, there is currently an enormous shortfall—which is triggering large increases in employer contributions and thus taxes this year and over the next several years.

[25] Scott, Brendan. "Low pension return may $oak taxpayers." *New York Post.* 21 Aug, 2010. 25 Aug. 2010. <http://www.nypost.com/p/news/local/low_pension_return_may_oak_taxpayers_sF9oJEnk8ySpdJwM6fPqWL>

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Unsustainable Promises

The New York State Constitution prevents the termination, diminishment or impairment of any plan benefit once it is granted to government employees.[26] Nevertheless, the State Legislature has acted to amend benefits through the years. The amendments had the effect of instituting a tiered system whereby employees, depending on when they were hired, are eligible for different benefit levels:[27]

- Tier 1 Before July 1, 1973
- Tier 2 July 1, 1973 through July 26, 1976
- Tier 3 July 27, 1976 through August 31, 1983
- Tier 4 September 1, 1983 through December 31, 2009
- Tier 5 January 1, 2010 to present

Pension benefits for all New York participants are based on years of credited service and the final average salary (FAS). FAS is calculated as the average of the wages earned during any 36 consecutive months of service when employee earnings were at their highest.[28] Annual annuity payments are also subject to cost of living adjustments (COLA), which are generally 50% of an annual inflation rate, but never less than 1% or more than 3%, and applied only to the first $18,000 of the annuity.[29] These benefits are not subject to state and local income taxes—true in only ten states. [30] New York is one of only three states that include overtime pay in calculating employees' FAS. [31]

- Let's examine the State's pension obligations for a Tier 4 employee who works for 30 years (the old "30 and out"), retires at age 55 and in the last years of service earns an

[26] Office of the State Comptroller, New York State and Local Retirement System, "Retiree Annual Statement—FAQ", 5 Aug. 2010. <www.osc.state.ny.us/retire/retirees/ras_frequently_asked_questions.htm#faq1>
[27] Office of the State Comptroller, New York State and Local Retirement System, "What Tier Are You In?", 24 Aug. 2010. <http://www.osc.state.ny.us/retire/members/find_your_tier.htm>
[28] Office of the State Comptroller, New York State and Local Retirement System, "Noncontributory Plan for Tier I Members (Section 75-d and 75-e), 4 Aug. 2010, www.osc.state.ny.us/retire/publications/zo1502.htm
[29] Office of the State Comptroller, New York State and Local Retirement System, "An explanation of Cost-of-Living Adjustments for retirees of the New York State and Local Retirement System", 23 Aug. 2010, http://www.osc.state.ny.us/retire/word_and_pdf_documents/publications/1800s/1863-colabrch.pdf
[30] Snell, Ronald and Waisanen, Bert. "State Personal Income Taxes on Pensions and Retirement Income: Tax Year 2009." September 2009. 24 Aug. 2010. <http://www.ncsl.org/default.aspx?tabid=12657> <http://www.ncsl.org/default.aspx?tabid=12657>
[31] Goldberg, Delen. "New York's Public Pensions are Socking Taxpayers." *The Post-Standard*. 15 Feb. 2009. 24 Aug. 2010. <http://www.syracuse.com/news/index.ssf/2009/02/new_yorks_public_pensions_are.html>

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average salary of $70,000.[32] Each of these employees will have contributed to their own pensions just over $8,000.[33] In return, they will have accrued over $1,000,000 in pension annuity payments after 25 years of retirement.[34] This amounts to a return of nearly 130 to 1. Stunningly, benefits were even more generous under Tiers 1 and 2, where no employee contributions were ever required. Tier 5 was a step in the right direction, with the math changing to a 28 to 1 return for the same employee, although Tier 5 employees cannot retire until they are 62 years old.

Historically, it was the case that states had to offer public workers plusher pensions because they earned lower salaries than their private-sector counterparts. In most cases today, however, government workers earn significantly more than their private sector counterparts. According to the U.S. Department of Labor's Bureau of Labor Statistics, public employee compensation (wages and benefits) is nearly 44% higher than private-sector compensation, though these comparisons vary meaningfully for different job classifications.[35] Yet in New York, the benefits keep on coming. During the 2005 legislative session, the New York Senate and Assembly passed at least 46 bills increasing pension benefits for public employees, at an estimated cost of more than $100 million.[36] In 2007, the New York State Legislature passed 21 pension-boosting bills.[37] Most stunningly, in the middle of a fierce battle to close a gaping deficit that delayed passage of a New York State budget for over four months, there were 50 bills before New York's Legislature, as of June 2010, that would add to pension benefits. [38]

The costs to the State for maintaining this whole system are skyrocketing. In fiscal year 1998, New York spent almost $3.5 billion on member benefits. By fiscal year 2008, the last year for which these data are available, New York spent over $7 billion, an increase of over 100% in ten

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[32] Final Average Salary (FAS) is calculated by the highest average wages earned during any three consecutive years.
[33] Assumes 3.9% salary growth per year, in accordance with actuarial assumptions listed in the New York State Complete Annual Financial Report (NYSCAFR FY2009).
[34] They receive 60% of their FAS annually plus COLA once they turn 62 (assumes 2.0% annual inflation for the purpose of estimating the COLA at 1%, or half the assumed inflation rate).
[35] ---. Bureau of Labor Statistics. *Employer Costs for Employee Compensation.* Washington, 2010, News release. <www.bls.gov/news.release/ecec.nr0.htm>. Note that this compensation gap essentially disappears in the case of jobs in the "management, professional and related" category, with all-in compensation for the public sector and the private sector virtually identical. However, large gaps exist within other job categories, creating the overall 44% disparity.
[36] McMahon, EJ. "Blame Albany", *New York Post*. 22 Dec. 2005. 5 Aug. 2010. Note that the article was found through The Empire Center for New York State Policy website: <http://www.manhattan-institute.org/html/_nypost_blame_albany.htm>
[37] Goldberg, Delen. "New York's Public Pensions are Socking Taxpayers." *The Post-Standard*. 15 Feb. 2009. 24 Aug. 2010. <http://www.syracuse.com/news/index.ssf/2009/02/new_yorks_public_pensions_are.html>
[38] Confessore, Nicholas. "Varied Bills for Special Interests Move Quietly Through Albany." *The New York Times.* 30 June 2010. 24 Aug. 2010. <http://www.nytimes.com/2010/07/01/nyregion/01handouts.html>

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years.[39] The financial impact on everyday New Yorkers is similarly meteoric. Over the last decade, taxpayers' annual pension contributions increased from $245 million in 2000 to $1.7 billion in 2010.[40]

This whole unsustainable proposition is why private sector employers have been moving to defined contribution, or 401(k), plans. From 1980 through 2008, the proportion of private sector employees enrolled in defined benefit plans fell from 38% to 20%.[41] For states and municipalities, it, unfortunately, is not possible to guarantee benefits that so thoroughly outpace a reasonable rate of return for pension funds without dramatically increasing taxpayer subsidies. As a result, New York taxpayers' contributions toward pension benefits in the last decade have grown to roughly $10 for every $1 that public employees contribute to their own pensions.

Pension Contributions

	Fiscal Year ($ in millions)								
	2009	2008	2007	2006	2005	2004	2003	2002	2001
Employee contributions (ERS & PFRS):	$ 273.3	$ 265.7	$ 250.2	$ 241.2	$ 227.3	$ 221.9	$ 219.2	$ 210.2	$ 319.1
Taxpayer contributions:	$ 2,456.2	$ 2,648.4	$ 2,718.6	$ 2,782.2	$ 2,964.8	$ 1,286.5	$ 651.9	$ 263.8	$ 214.8
Ratio of taxpayer contributions to employee contributions:	9.0	10.0	10.9	11.5	13.0	5.8	3.0	1.3	0.7

Recent Underperformance Has Exacerbated This Dangerous Imbalance

New York State's Pension System faces significant challenges that have been made worse by dramatic underperformance of the Fund in recent years under the current Comptroller.

Note the summary of performance for a broad universe of 57 public pension funds over the last three fiscal years. In each case, New York's Pension Fund returns are substantially below the median.[42] Even in fiscal year 2010, when the State Comptroller's office announced with much

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[39] Office of the State Comptroller, New York State and Local Retirement System. "2009 Comprehensive Annual Report." Albany, NY, 2010. 21.
<http://osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_09.pdf>

[40] Gershman, Jacob. "Cuomo, Lazio Spar Over Pensions". *The Wall Street Journal*. 7 Jul. 2010. 6 Aug. 2010.
http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748704862404575351420074469874.html

[41] Butrica, Barbara A., Iams, Howard M., Smith, Karen E., and Toder, Eric J., "The Disappearing Defined Benefit Pension and Its Potential Impact on the Retirement Incomes of Baby Boomers," Social Security Bulletin, Vol. 69, No. 3, 2009. 24 Aug. 2010. <http://www.ssa.gov/policy/docs/ssb/v69n3/v69n3p1.html>

[42] R.V. Kuhns & Associates Public Pension Performance (> $2bn) Report for the Fiscal Quarter Ending March 31, 2010, p.17. This perfectly overlaps with New York State's fiscal year and is a direct data match. The R.V. Kuhns data are available online at:
http://www.pera.state.nm.us/pdf/PERAFinancialArticles/FY10Q3PerformanceAnalysis.pdf (accessed August 2010).

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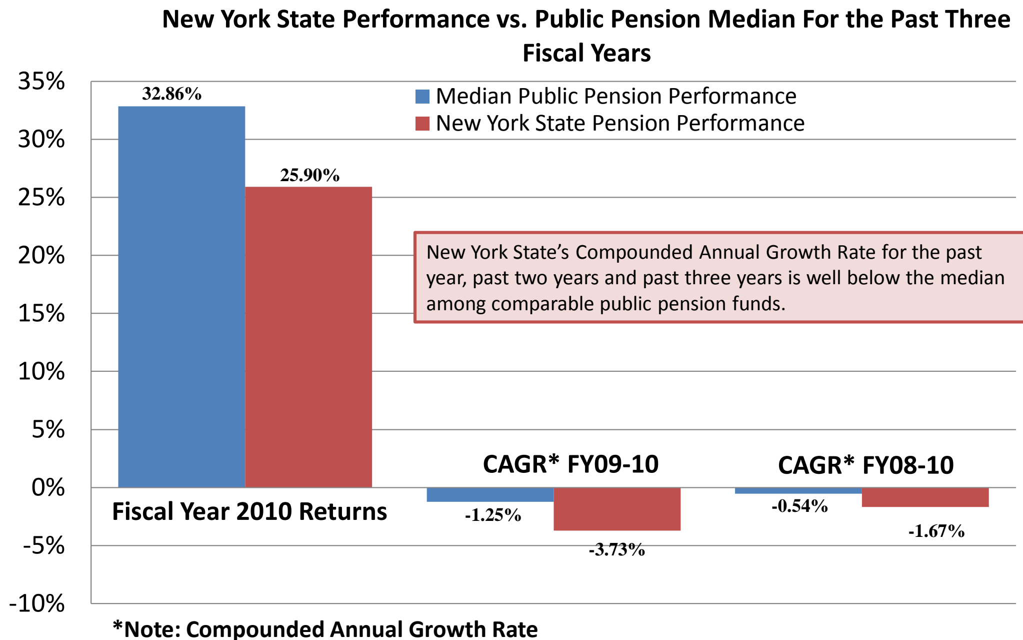
fanfare that New York's Pension Fund had achieved returns of 25.90%, the Comptroller underperformed the median by almost 7 full percentage points, an enormous amount.



Source: These data are taken from R.V.Kuhns & Associates and are for fiscal years ending on 3/31

Of course, the most appropriate benchmark for a public pension fund is not a blend of the overall equity and fixed income markets, or even an index of public pension funds; the right benchmark is the investment return assumption stipulated by the Fund. The reason for this is because, as previously stated, the Fund must deliver on its investment return assumption, or any shortfall is passed on to the taxpayer. In other words, even if the Fund outperformed other public pension funds (which the R.V. Kuhns data show it definitively <u>did not</u> over the last three years), it would still have lost ground relative to its benchmark and thus triggered tax increases. <u>In fact, the Fund's cumulative underperformance, relative to its 8% target investment return, over the past 3 years, totals nearly $50 billion.</u>

If all the Fund had done was keep pace with the median returns for public pension funds in the past year, it could have reduced this cumulative underperformance by $7 or $8 billion—a material improvement for New York State taxpayers. It has been rumored, though neither refuted nor corroborated by the Comptroller, that a significant portion of this underperformance stems from the Comptroller's decision to suspend customary rebalancing at the trough of the equity market.

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With the revelation of these aggregated data as compared to New York State's Fund performance, there should be little debate going forward from this point: our Fund has performed significantly worse than the median performance of other comparable public pensions over the years that overlap with the current Comptroller's tenure.

Looking back further, R.V. Kuhns & Associates compiled aggregate returns for a broad universe of 89 representative public funds over the ten fiscal years between 2000 and 2009. The median compounded annual growth rate in that decade for a group of 89 public pensions that included New York State's was 3.04%. New York State's Fund, individually, returned 3.06% in that period, just above the median, which means our better relative performance in the earlier part of this decade has been weighed down substantially by poor recent performance.[43]

Why Does All Of This Matter To New Yorkers?

Most New Yorkers are not aware that whether the Pension Fund meets its obligations or not directly influences our State's highest-in-the-nation tax burden. The overall management of the Fund is akin to a pay-as-you-go scheme, with annual tax collections that plug shortfalls for any year there are shortfalls (based on a five-year smoothing mechanism). It is the great shell game the State Comptroller plays with New York's Pension System—assume any shortfall is covered by future tax increases without laying out a multi-year forecast on what that means for taxpayers.

As losses are realized and factor into the Fund's assessment through a five-year smoothing mechanism, they trigger increases in contributions by the State and local governments. These governments pay a certain percentage of their total payroll costs into the Pension Fund. As this percentage rises, the costs of State and local government rise, triggering either tax increases or cuts in other government services. Since our elected officials have proven highly reluctant to administer spending cuts, for all practical purposes pension underperformance means tax increases for all New Yorkers. The problem is especially significant for New Yorkers outside of the five boroughs of New York City, since New York City has a separate pension system. (New York City residents still bear some of the cost of the State Fund through their state tax burden.)

So, while many New Yorkers consider the Fund to be an abstract matter that only affects the roughly 1 million retirees, beneficiaries and members, the harsh reality is that it has a significant impact on all of us.

[43] Note: New York State's fiscal year ends on March 31 and R.V. Kuhns' data from 2000 to 2009 are for fiscal years ending June 30, 2009.

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In fact, this "significant impact" is about to grow much larger in the next few years. In just the last three years under the current Comptroller's tenure, the Fund underperformed its 8% target by nearly $50 billion—in other words, if the Fund had actually achieved its 8% target, it would be nearly $50 billion larger. Since the Fund's performance, in fact, was negative, this gigantic shortfall will be passed on, over time, to taxpayers.

Hiding the Impact: A Raid By Any Other Name

Most observers recognize (and we certainly strongly agree) that New Yorkers cannot afford higher taxes. So, with the coming tax increases triggered by the Fund's underperformance, what's a politician to do?

Simple: cover it up. Specifically, in this case, create a scheme to limit near-term contributions without being honest about the problem, and kick the can down the road past the election so voters won't see the problem for years. Here is how it all started back in 2009:

> ….Comptroller DiNapoli has proposed legislation…to ease the…impact of the required contributions…on tax rates. This legislation, which has been introduced in the Senate (S5826) and in the Assembly (A8899) would permit employers to amortize the increase in the required contribution rate over a ten year period. In the future…the legislation would permit a gradual decline in the required contribution rate. The portion of the payment that exceeds the actuarial contribution rate would be used to further reduce previously amortized amounts. When all amortizations are exhausted any additional contributions will fund contribution stabilization accounts, which would be used to offset the impact of any future increases in the employer contribution rate. Enactment of this proposal would benefit employers by providing them with an option which would lessen the budgetary volatility of funding required pension contributions.[44]

After initially supporting the borrowing plan he created,[45] then taking pains to deny knowledge about the borrowing plan[46] and then finally assailing the borrowing plan,[47] the current

[44] Murray, Kevin. Letter to employers regarding final contribution rates for February 1, 2011 payment. September 2009, 24 Aug. 2010, 2. <www.osc.state.ny.us/retire/word_and_pdf_documents/employers_files/2011_final_rates/ers_final_rates_letter-2011.pdf>

[45] Hakim, Danny. "State Plan Makes Fund Both Borrower and Lender." *The New York Times.* 11 June 2010. 24 Aug. 2010. <http://www.nytimes.com/2010/06/12/nyregion/12pension.html>

[46] Benjamin, Elizabeth. "Controversial pension plan could sink Tom DiNapoli." *New York Daily News.* 14 June 2010. 31 Aug. 2010. <http://www.nydailynews.com/news/2010/06/14/2010-06-14_controversial_pension_plan_could_sink_state_controller_tom_dinapoli_.html>

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Comptroller supported the borrowing plan, even going to great lengths to characterize this scheme as a "smoothing," forcing municipalities to establish reserve accounts in good times that will offset the increasing contribution levels in bad times, like today.[48] However, the Comptroller won't release a long-term forecast and his underlying assumptions so taxpayers can assess the borrowing plan. Based on New York State Division of the Budget forecasts, it is unlikely that these reserve accounts will be utilized in the next 15 years, perhaps even longer, due to the depths of our pension problems. The reduced contributions will have to be paid back in the future with interest. This is a textbook definition of a borrowing—which is why virtually every major publication covering this scheme has characterized it as such.[49]

In fact, it's worse than that. The Comptroller's borrowing plan, passed as part of this year's budget, is nothing more than a disguised raid of the Pension Fund. For decades, the Comptroller has served as the last line of defense against politicians seeking to borrow from the Pension Fund to balance the State budget, or defer contributions to the Pension Fund for the same purpose. But the Comptroller's borrowing plan does exactly that; by reducing the State's contribution to the Pension Fund by just over $200 million, it helped the State close its budget gap. By deferring payments due today and paying them in the future with interest, it borrows from the Pension System on an unprecedented scale. In just the first six years, the plan would allow the State and local governments to borrow approximately $10 billion, with future interest costs in excess of $3 billion.[50]

As stunning as this act of fiscal gimmickry may be, the approach was tried once before—and it failed. Comptroller DiNapoli's predecessor, Alan Hevesi, authored a similar plan several years ago. Of the $655 million he borrowed (a tiny fraction of what Comptroller DiNapoli now proposes to borrow), approximately $400 million remains outstanding, and to this day annual

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[47] Office of the New York State Comptroller. "DiNapoli: Pension Fund Will Not Be Raided." Press release, 14 June 2010. <http://www.osc.state.ny.us/press/releases/june10/061410.htm>

[48] Budget Bill No. A09710 & S6610-C, Part TT, Section 103 (lines 33-35): "…if the amortizing employer's annual bill for the fiscal year does not include an amount attributable to a prior amortization, then the employer's graded payment shall be paid into the employer contribution reserve fund…."

[49] Hakim, Danny. "Comptroller Backflips on Pension Borrowing." *The New York Times*, 15 June 2010; Gershman, Jacob. "Shutdown Fears Wane in Albany," *Wall Street Journal*, 14 June 2010; Editorial, "Double Talk: After Swearing Off Borrowing, the Governor is Trying to Take Out a Loan," *New York Daily News,* 19 June, 2010; Madore, James T. "Will Albany Borrow from Pension Fund, In Order to Pay Into It?" *Newsday*, 12 June, 2010; "DiNapoli to NY Legislature: Hands Off Pension Fund," *New York Post*, 14 June, 2010.

[50] According to calculations based on the New York State Division of the Budget projections and the Spring 2010 Market Recast, Pension Amortization Proposal General State Charges. The Division of the Budget's previous projection indicated over $11 billion in borrowing.

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repayment costs exceed $75 million. It remains an open question as to how anyone looking out for the public welfare could seek to replicate and dramatically expand on such a failed program.

For the average New Yorker this year—the 2010 *election year*—rates will stay the same as in 2009, when total employer contributions were $2.5 billion or so. That comes to just over $500 for every household outside of New York City (the City has its own separate pension system but bears some of the state cost through state taxes). Due to the underperformance of the Fund, government employer contributions are expected to increase dramatically and, when combined with interest costs, will cause total contributions to increase by 2017 to over $1,800 per household. The net effect of the underperformance and borrowing costs is a $1,300 per household increase in pension costs.[51]

Unfortunately for New York taxpayers, the actual costs of this new scheme could be even more devastating, as the borrowing plan that ultimately passed the State Legislature on August 3, 2010 allows for this to go on each and every year forever. So these significant increases would not come in 2017, as called for under the original plan incorporated in the proposed budget, but the borrowings would be much larger over time, the interest costs would grow accordingly, and the bill would not come due for even longer. It is a Ponzi scheme that, like Bernie Madoff's, would eventually collapse on itself.

Indeed, the plan's true costs depend upon the performance of the State's Pension Fund. And according to previous reports the Comptroller has not disputed, his office is assuming—fantastically—a repeat of market conditions after the 1987 crash, including the halcyon years between 1988 and 1998 when returns averaged nearly 14%.[52] If the market underperforms that rate—what amounts to the best ten-year span in the Fund's history—then this borrowing plan's reported costs could be even higher. To put this expectation into perspective, assuming the same asset mix as the current Pension Fund portfolio while making reasonable predictions for returns on fixed income and alternative investments, equities would have to skyrocket, with the Dow needing to reach 80,000 (versus a current level slightly above 10,000) by 2022 for the Comptroller's market assumptions to hold up.

Should the Fund return anywhere less than an astounding 14% average over the next ten years, it would mean even greater financial pressure on the State and municipalities and a mountain of new debt—both of which could lead to substantial underfunding.

[51] About $1,000 of that hidden tax is due to the Fund's underperformance under DiNapoli and $300 is due to interest on his borrowing scheme.

[52] Hakim, Danny. "Pension Costs for Local Governments May Triple." *The New York Times.* 7 Jul 2009. 31 Aug. 2010. <http://www.nytimes.com/2009/07/08/nyregion/08pension.html>

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The most remarkable aspect of this plan is that it passed at all. It is unambiguously bad for both taxpayers, who will be footing a rapidly increasing pension bill for years despite oft-repeated claims that it is "fully funded," and for public employees, who will see the funding status of their Retirement System decline precipitously as a result of this borrowing plan.

V. Rules Matter: Politicians Take Advantage of Public Pension Accounting Rules To Hide Deficits

The Governmental Accounting Standards Board, or GASB, is the rulemaking body for state and local government accounting practices, which includes policies surrounding public pension funds. While GASB establishes a long series of rules and practices that affect public pension funds, we focus on four of the most important practices for the purposes of this white paper:

1) Discount rate

The proper discount rate is a critical assumption that can create swings for the Fund in the tens of billions of dollars. GASB advises that a discount rate "be based on an estimated long-term investment yield for the plan, with consideration given to the nature and mix of current and expected plan investments."[53] This approach of basing the discount rate on an assumption of long-term investment returns is dramatically different from the standard followed by all corporations and nonprofits and every financial practitioner and economist of good standing.

Here is one example of the pernicious effect of GASB's rule: let's say a public pension fund manager decides to substantially increase the risk profile of his investments. Normally this would lead to the assumption of higher returns (even though it also substantially increases the risk of loss). The use of a higher investment return assumption would then translate into the use of a higher discount rate, which reduces the present value of future liabilities. By taking on substantially more risk (and substantially increasing the risk of loss), then, the pension fund would actually be able to reduce its stated liabilities. This twisted practice has no grounding in basic economics or finance or even common sense, yet it is a fundamental foundation of public pension accounting.

In a 2007 speech, former SEC Chair Arthur Levitt Jr. (whose father, Arthur Levitt Sr., was widely admired for his stewardship of the New York State Pension Fund during its fiscal crisis in the 1970s), blamed these accounting rules for the major pension problems in our country, making the point in no uncertain terms that they "fail to reflect accurately" both the cost of the benefits

[53] GASB Statement 25

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owed to public workers and the value of the assets set aside to pay them.[54] (We will address his latter claim soon enough.)

2) Investment return assumption

Unlike in the private sector, GASB suggests that the investment return and the discount rate are identical. We'll discuss in the next section why that should not be the case, and in fact is not for any entities other than the public pension funds governed by GASB. Just as importantly, GASB provides very limited prescriptions around what might constitute an acceptable "estimated long-term investment yield for [pension plans]" and, as discussed above, does not offer any consideration for the appropriate risk profile and what that might mean for investment returns. But given the nature of the underlying liabilities, it is critical that GASB formulates investment return guidelines that take risk into account, lest it continue to push public pensions into increasingly risky investments (as has been very much the case in recent years). In fact, the current Comptroller has sought to increase the Fund's exposure to alternative assets such as private equity firms and hedge funds[55] while blaming those same firms for contributing to our nation's recent economic collapse.[56]

3) Asset valuation

To measure against the present value of a pension fund's discounted liabilities, one must tally up its current assets. This would seem straightforward enough—presumably, one could just take the market value of the underlying assets.

Unfortunately, that's not how public pension accounting generally works. Public pension funds are allowed to use a variety of accounting gimmicks to restate their asset values. New York's Pension Fund uses an "actuarial asset value" that incorporates two accounting devices that have little relation to the market value of assets.

First, asset values are smoothed out over a five year horizon. In other words, if the Fund owns stock in Microsoft, and Microsoft trades on the stock exchange at $25.00 per share, the actuarial value of Microsoft at that time could be $20, $30 or some other number that reflects a five-year smoothing.

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[54] Levitt Jr., Arthur. Remarks. New York Private Equity Conference. New York, NY. 30 Oct. 2007, p. 3 (http://www.pebc.ca.gov/images/files/071113_Pension.pdf)

[55] Hakim, Danny. "DiNapoli Reports Plunge in the State Pension Fund." *The New York Times.* 29 May 2009. 31 Aug. 2010. <http://cityroom.blogs.nytimes.com/2009/05/29/dinapoli-reports-plunge-in-state-pension-fund/>

[56] "Interview with Thomas P. DiNapoli, NYS Comptroller." *The Empire Page.* 26 Aug. 2010. 31 Aug. 2010. <http://www.empirepage.com/2010/8/26/interview-with-thomas-p-dinapoli-nys-comptroller>

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Second, a component of the actuarial asset value allowable by GASB includes the present value of future State and local government contributions (paid for through state and local taxes) and contributions by employees. These "assets" are not really there, but rather represent the expectation of future payments. To make matters worse, given limited disclosure, the employers are generally not aware of the magnitude of their future obligations.

But here's the even greater problem. Because of this provision, **as long as a state is willing to stipulate that it will ALWAYS pass through pension fund shortfalls to the taxpayers and has a robust mechanism to do so, IT WILL ALWAYS BE FULLY FUNDED**.[57] This present value tax account will increase to reflect higher future taxes. For example, in New York's 2004 Complete Annual Financial Report (CAFR), these present values were negligible, less than $2 billion in aggregate,[58] but in the most recent 2009 CAFR, the total exceeded $20 billion.[59] This amounts to a more than ten-fold increase in the present value of future employer contributions (derived from state and local taxes) in order to fill the hole created over that period of time.

4) Amortization

Currently, GASB allows public funds to amortize changes in policies or even benefits over a period of up to 30 years, dramatically reducing the impact on any one year, though there is an effort to change this standard to 15 years. A move to 15 years would double the annual impact of losses (and gains), further draining cash flows in bad environments—yet it would likely still be more generous and less rigorous than current private sector standards.

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[57] Office of the State Comptroller, New York State and Local Retirement System. "2009 Comprehensive Annual Report." Albany, NY, 2010. 96.
<http://osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_09.pdf>: "Under the aggregate funding method, the difference between the actuarial liabilities above and the actuarial value of present assets is funded as a level percentage of salary over the future working lifetimes of current members."

[58] Office of the State Comptroller, New York State and Local Retirement System. "2009 Comprehensive Annual Report." Albany, NY, 2010. 76.
<http://osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_09.pdf>

[59] Office of the State Comptroller, New York State and Local Retirement System. "2009 Comprehensive Annual Report." Albany, NY, 2010. 100.
<http://osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_09.pdf>

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VI. Private Sector Standards: Not Perfect, But More Honest And Realistic

Much like GASB oversees public pension plans, the Financial Accounting Standards Board (FASB) oversees private ones. Despite the interrelationships between FASB and GASB (they are both part of the Financial Accounting Foundation), on the critical assumptions outlined above, they could not be more different:

1) Discount rate

FASB follows the same basic principles suggested by modern economics and finance: it directs private pensions to discount their obligations at a rate consistent with the yields of high quality (AA rated or better) corporate bonds:

> [A]n employer may look to rates of return on high-quality fixed-income investments in determining assumed discount rates. The objective of selecting assumed discount rates using that method is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the pension benefits when due. Notionally, that single amount, the projected benefit obligation, would equal the current market value of a portfolio of high-quality zero coupon bonds whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments.[60]

This would mean applying different discount rates to obligations in different years. For example, pension payments due in 2011 would be discounted at the 1-year AA bond rate, while pension payments due in 2040 would be discounted at the 30-year AA bond rate. The average discount rate will depend on the average age, retirement age and life expectancy of public employees, but, for the Fund, in the current interest rate environment, would almost certainly be less than 6% under the FASB standard, as it is applied to corporations and nonprofits.[61]

So, if New York's Pension Fund were managed by a corporation, say IBM or GE, then it would be expected to use a discount rate of less than 6%. But New York State is not a corporation. State pension benefits are constitutionally protected, and thus are substantially less "risky" than corporate pension benefits, which are considered unsecured obligations and are often compromised, unfortunately, in a corporate bankruptcy. Basic principles of economics would dictate a lower discount rate for the Pension Fund than for a corporation.

[60] Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 87 Employers' Accounting for Pensions, 2008.

[61] As of July 2010, the IRS lists the 1 year AA bond rate as 1.13%, the 15 year AA bond rate as 5.53% and the 30 year AA bond rate as 6.02%.

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How low might the proper rate be? Since public pension benefits are virtually risk-free, many commentators have argued that the discount rate should be equal to the risk-free rate, or U.S. government treasuries.[62] With the 30-year Treasury bond currently yielding less than 4%, this would suggest a discount rate of less than 4%.

Other commentators argue that New York State's municipal bond rates are better indicators of the proper discount rate. In fact, GASB is already considering supplementing the practice of using the rate of return on public pension fund investments as the discount rate with a proposal to use "a high-quality municipal bond index rate" for a portion of future benefit payments.[63] The result, according to Moody's, is that discount rates will almost certainly be lower with "large increases" in the reported deficits.[64]

We're left, then, with a range of possible outcomes that demands serious debate and review: an upper range of just below 6%, consistent with the actual practices of the private sector, and a lower range of closer to 4% or less, consistent with the *standards* set by the private sector when applied to public sector obligations that carry important differences.

2) Investment return assumption

What is a *sustainable* long-term rate of return for a pool of assets as large as the State Pension Fund? There is no simple answer, since no one has a crystal ball. However, there are some important guidelines to consider:

i) When in doubt, it is better to err on the side of caution, as taxpayers will bear the cost if you are wrong.
ii) Past returns are not necessarily a good indication of future returns. As Warren Buffet often warns, investors of all stripes should not make the mistake of "looking in the rearview mirror."

[62] Novy-Marx, Robert and Rauh, Joshua. "The Intergenerational Transfer of Public Pension Promises," National Bureau of Economic Research, Working Paper 14343 (September 2008): 7

[63] "States May Face Pension Pressure as New GASB Rules Widen Funding Deficits." *Bloomberg News.* 7 July 2010. 26 Aug. 2010. <http://www.bloomberg.com/news/2010-07-09/states-may-face-pension-pressure-as-new-gasb-rules-widen-funding-deficit.html>

[64] "States May Face Pension Pressure as New GASB Rules Widen Funding Deficits." *Bloomberg News.* 7 July 2010. 26 Aug. 2010. <http://www.bloomberg.com/news/2010-07-09/states-may-face-pension-pressure-as-new-gasb-rules-widen-funding-deficit.html>.

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For example, it is often argued by advocates of higher investment return assumptions at public pension funds that long-term rates of return are around 8%. The primary driver of these historical rates is equity returns that have approached 10% over a long period of time. Notably, the very folks who benefited enormously from that rate of appreciation in the 20th Century are among the first to understand and argue that those returns cannot be expected in the future. Here is Warren Buffett again:

> Let me summarize what I've been saying about the stock market: I think it's very hard to come up with a persuasive case that equities will over the next 17 years perform anything like—anything like—they've performed in the past 17. If I had to pick the most probable return, from appreciation and dividends combined, that investors in aggregate—repeat, aggregate—would earn in a world of constant interest rates, 2% inflation, and those ever hurtful frictional costs, it would be 6%.[65]

Why would this be the case, considering historical returns have been higher? To oversimplify matters a bit, there are three primary components to equity appreciation in the long-term: real GDP growth (as earnings growth cannot outpace GDP growth in the long-term), inflation (the first two, taken together, would be nominal GDP) and dividends. For much of the 20th century, real growth averaged 3.3%, inflation averaged 3.1% and dividends amounted to approximately 4% of the underlying equity value, leading to a cumulative long-term equity return of approximately 10%.[66]

More recently, since 2000, annual inflation has averaged only 2.5%, dividend yields 1.8% and GDP growth 1.9%.[67] That comes closer to 6% than 8%.

Looking ahead, the long-term view is much more consistent with recent history. The 20th Century witnessed America's transformation from a largely agrarian economy to the world's largest industrial power—a level of growth that cannot be replicated over the long-term by an economy as mature as America's. While there is some disagreement about this (generally, those who disagree favor a lower expected growth rate), most prognosticators expect real GDP growth to be close to 2% in the long run.

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[65] Buffett, Warren and Loomis, Carol. "Warren Buffett on the Stock Market," *Fortune Magazine*, 22 Nov. 1999. 25 Aug. 2010. <http://money.cnn.com/magazines/fortune/fortune_archive/1999/11/22/269071/index.htm>
[66] See Alpha and Vega (both anonymous), "Are Stocks Overvalued?". Risk Over Reward. Oct. 25, 2009. Aug. 23, 2010; http://www.riskoverreward.com/2009/10/are-stocks-overvalued.html Dudley and others 1999; Wadhwani 1998; http://www.multpl.com/inflation/table; http://www.multpl.com/s-p-500-dividend-yield/table; and Officer, "Lawrence H. What Was the U.S. GDP Then?" MeasuringWorth. 2010. 31 Aug. 2010. <http://www.measuringworth.org/usgdp/>
[67] *Ibid.*

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After the efforts of the Volcker Fed in the early 1980s, inflation has generally been much lower. The deflationary impact of the growth of the Chinese and Indian labor markets has further depressed inflation over the past decade. Current long-term market forecasts (as supported by spreads relative to Treasuries in the TIPS market) suggest long-run inflation rates closer to 2%.[68]

Finally, dividends, once a large component of equity returns, have declined dramatically in recent decades. Currently, the dividend yield on the S&P 500 is approximately 1.9%.[69]

In other words, both long-run expectations and (the post-dot com bubble) recent history suggest long-term equity returns of 6%, not the 10% we experienced during America's transformation into an industrial power.

The experts uniformly agree:

> There is a near certain probability that the financially based global economy of the past half-century will not return, nor will we experience the steroid driven growth excesses that it facilitated.[70]
> --*Bill Gross, CEO of PIMCO*

> … it will be interesting to see whether companies have reduced their assumptions about future pension returns. Considering how poor returns have been recently and the reprises that probably lie ahead, I think that anyone choosing not to lower assumptions—CEOs, auditors, and actuaries all—is risking litigation for misleading investors. And directors who don't question the optimism thus displayed simply won't be doing their job.[71]
> --*Warren Buffett*

> Why use an 8% assumption? Because if you used more conservative numbers, as the academic studies suggest, you would have to make larger current contributions to the pensions, when state and local governments and schools are already in fiscal trouble…This is going to end in tears for many states and municipalities. I mean real tears. Pension funding in some states will be required by law to consume 25-30% or more of tax revenues. That is going to mean much higher

[68] As of August 27, 2010, the spread between 10 year TIPS and 10 year Treasuries was 1.61%, and the spread between 30 year TIPS and 30 year Treasuries was 2.02%.
[69] "Dividend Yield for Stocks in the S&P 500," indexArb. Aug. 27, 2010: http://indexarb.com/dividendYieldSortedsp.html
[70] "The Future of Investing: Evolution or Revolution?" Investment Outlook April 2009. 11 Aug. 2010 <http://media.pimco-global.com/pdfs/pdf_uk/IO%20April%2009%20UK.pdf?WT.cg_n=PIMCO-EUROPE&WT.ti=IO%20April%2009%20UK.pdf>
[71] Buffett, Warren and Loomis, Carol. "Warren Buffett on the Stock Market," Fortune Magazine, 10 Dec. 2001. 11 Aug. 2010. <http://money.cnn.com/magazines/fortune/fortune_archive/2001/12/10/314691/>

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taxes or reduced services.[72]

--John Mauldin, president of the investment advisory firm Millennium Wave Advisors, LLC

Of course, the Fund does not consist of 100% U.S. stocks; it has meaningful allocations to international stocks, fixed income, real estate, private equity and hedge funds managing various strategies. But the widely-held diminished expectations for equities over the long run are instructive and the right argument why historically high returns are not likely to be replicated in the coming decades—certainly not likely enough to bet on with taxpayer money.

For example, let's take a look at the international stock portfolio. Much of what has been argued here about U.S. equities could be applied to international stocks as well—equity appreciation is a function of underlying economic growth and dividends. Economic growth for markets outside the U.S. has been remarkably similar to U.S. economic growth for the past four decades—in fact, the U.S. share of global GDP in 2009 (approximately 27%) was virtually identical to its share in the early 1970s, as faster growth in Asia was offset by slower growth in Europe, leading the US share to remain constant.[73] The dividend yield on international stocks is slightly higher today than for U.S. stocks,[74] but this slight advantage can be more than offset by currency risks embedded in international stocks. Unfortunately, there's no lifeline in international stocks; over the last 10 years, the equity returns of the MSCI EAFE index have been virtually identical to (actually, slightly less than) the returns of U.S. stocks.[75]

What about fixed income? Long-term return data for fixed income is less frequently cited, but the best available data suggest a diversified bond portfolio would have generated a 5.5% return over most of the past century.[76] Unlike equities and their greater volatility, this performance has been more consistent, as various bond indices suggest more recent fixed income returns (in the midst of the longest and strongest bull market for fixed income in decades) of between 5% and 6.5%.[77] Given current yields, there is a compelling argument that fixed income in the next few years will underperform its historical averages, but our arguments center, appropriately for the Fund, on a long-term analysis. So, unfortunately, there is no salvation here, either.

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[72] Mauldin, John. "The Problem with Pensions." Seeking Alpha. 8 Aug. 2010, 11 Aug. 2010. <http://seekingalpha.com/article/219420-the-problem-with-pensions>

[73] Perry, Mark J. "U.S. Share of World GDP Remarkably Constant." Carpe Diem. 19 Nov. 2009, 31 Aug. 2010. <http://www.mjperry.blogspot.com/2009/11/us-share-of-world-gdp-remarkably.html>

[74] Current dividend yield of MSCI EAFE index is 2.62%.

[75] According to the MSCI Barra website (www.mscibarra.com), through August 30, 2010, the trailing 10 year return for the EAFE index was -1.23%, vs. -1.07% for MSCI's Investable Market 2500 Index.

[76] www.personal.vanguard.com/us/insights/saving-investing/model-portfolio-allocations.com

[77] www.us.ishares.com/product_info/fund/performance/AGG.htm

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Finally, what about alternatives—real estate, private equity and hedge funds? Recall that the current Comptroller has been seeking to increase the 25% cap on alternatives imposed by the Legislature,[78] even while arguing that such firms "knowingly made risky bets in search of quick profits at any cost . . . truly the worst of Wall Street."[79] This glaring inconsistency aside, even the actuaries believe that there is relatively little outperformance to be gained from a diversified portfolio of alternatives. For example, the Pension Consulting Alliance's (PCA) 2010 10-year capital market projections are based on the view that real estate will underperform equities by about 2%, hedge funds will perform in line with equities and private equity will outperform equities by about 3%,[80] leading to an alternatives portfolio that would outperform equities by 1% at most. However, these different asset classes do provide some diversification and thus help mitigate volatility. The reality is that, given the correlations between private equity, in particular, and some hedge funds to U.S. equities, it is unrealistic to expect meaningful outperformance to be driven by the alternatives portfolio, particularly net of fees. At roughly 20% of the current Fund, this part of the portfolio also does not change the ultimate conclusion that long-term returns, if managed well with a prudent risk profile, are likely to be within the range of 5% to 6% and certainly not 8%.

Not coincidentally, Buffett assumes an expected long-term rate of return for his Berkshire Hathaway plan assets, across all asset classes, of 6.9%.[81] Buffett is considered by many to be one of the all-time great investors and has grown the market value of his holding company at a compound annual rate of 22% over the last 45 years.[82] Yet, he is the first to acknowledge that he established his formidable track record over a unique period in American history that won't be replicated in this century. In addition, the 2010 Wilshire Report, based upon data from the most recent financial and actuarial reports provided by 125 pension funds including New York's,

[78] Cataldo, Adam and McDonald, Michael. "States Double Down on Hedge Funds as Returns Slide." *Bloomberg*. 14 Aug, 2008. 10 Aug. 2010. <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=amI_UFrp4XB4>
[79] "Interview with Thomas P. DiNapoli, NYS Comptroller." *The Empire Page.* 26 Aug. 2010. 31 Aug. 2010. <http://www.empirepage.com/2010/8/26/interview-with-thomas-p-dinapoli-nys-comptroller>
[80] Pension Consulting Alliance. "2010 Ten-Year Return, Risk, and Correlation Assumptions." January 2010. 2. <http://www.pensionconsulting.com/pdfdocs/Nominal%202010%20Assumptions%20Short%20Form%20Final_1-10.pdf>
[81] Berkshire Hathaway, Inc. "2009 Annual Report." 25 Aug. 2010. 53. <http://www.berkshirehathaway.com/2009ar/2009ar.pdf>
[82] Berkshire Hathaway, Inc. "2009 Annual Report." 25 Aug. 2010. 4. <http://www.berkshirehathaway.com/2009ar/2009ar.pdf>

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forecasts that none of them can be expected to earn long-term asset returns that equal or exceed 8%.[83]

It is for these reasons that we believe a far more realistic investment return assumption is in the range of 5% to 6% and that 8% is irresponsibly fanciful. This logic reflects the recommendation to the board of The California Public Employees' Retirement System (CalPERS) by its advisor, Blackrock:

> You're not going to get a 7.6% return when the U.S. is seeing a subpar (economic) growth rate of 2% to 3%...You'll be lucky to get 6% ... maybe 5%.[84]
> *--Laurence Fink, chairman and CEO of BlackRock Inc.*

Given the weight of the evidence, logic and of expert opinion, only one question remains: **What does Tom DiNapoli know that Warren Buffett doesn't?** How can any public pension realistically expect to outperform the great investors?

No public pension should,[85] and there is a growing realization of this view creeping into the thinking of public pension trustees as evidenced by rumors that CalPERS is considering reducing its investment return assumption to 6% as soon as this December—conveniently after the next election.[86]

3) Asset valuation

For the purposes of calculating funding levels, FASB mandates that pension assets are marked to market,[87] a stark contrast to the actuarial asset value approach adopted by New York. By not marking assets to market, New York further obscures the truth about its pension funding. Even so, were New York to mark its pension assets to market, it may not necessarily translate into lower values. In 2008, for example, the market value of New York's Pension assets was very

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[83] Wilshire Consulting. "2010 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation". March 2010. 13. <http://www.wilshire.com/BusinessUnits/Consulting/Investment/2010_State_Retirement_Funding_Report.pdf>

[84] "Fink gives CalPERS a reality check." *Pensions & Investments.* 10 Aug. 2009. 11 Aug. 2010. <http://www.pionline.com/article/20090810/PRINTSUB/308109987>

[85] The same applies to corporate pension funds, even though there are some corporate pension funds that also maintain higher, and equally unrealistic, long-term investment return assumptions.

[86] Chon, Gina. "Calpers Confronts Cuts to Return Rate." *Wall Street Journal*. 1 March 2010. 25 August 2010. <http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748703316904575092362999067810.html>

[87] FASB allows for exceptions when calculating the income statement impact and future contributions, but not for calculating funding ratios.

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close to the actuarial value, largely by coincidence.[88] In 2009, however, as the market sell-off decimated the asset base, the actuarial value of Fund assets would have smoothed the decline.

Our ability to assess the impact of mark-to-market asset valuation is hamstrung by the limited transparency provided by New York's Comptroller. A recent example of another public pension system performing a mark-to-market valuation, however, is hardly encouraging. For 2008, New York City's chief actuary, Robert C. North, calculated the mark-to-market value of assets in the five funds that make up New York City's Pension System, using the same discount rate for liabilities as New York State, and revealed a $45 billion funding deficit compared to the "fully funded" status that the more misleading, GASB-approved accounting method reported.[89, 90]

But the larger problem arises from the practice of using the present value of future tax payments to calculate the funding ratio. This is one of the great fictions of New York State: as long as the Comptroller is willing to raise contribution rates (and thus taxes) as high as is necessary in the future, then the Pension Fund will always *seem* fully funded.

4) Amortization

FASB's policy on assessing the impact of benefit changes is to amortize them over the average remaining service lives of the employees.[91] Since this would surely translate into a shorter amortization period, it would also increase the amount to be expensed each year. Regrettably, given the limited transparency provided by the New York State Comptroller's office, it is impossible to predict the impact of a change to conform to private sector practice.[92]

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[88] Office of the State Comptroller, New York State and Local Retirement System. "2008 Comprehensive Annual Report." Albany, NY, 2010. 63. <http://www.osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_08.pdf>: The market value of assets in FY 2008 was $153.9 billion. Office of the State Comptroller, New York State and Local Retirement System. "2009 Comprehensive Annual Report." Albany, NY, 2010. 48. <http://osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_09.pdf>: The actuarial value was $151.7 billion.

[89] Cooper, Michael and Walsh, Mary Williams. "Pension Fund Short or Full? Depends on the Evaluator." *The New York Times*. 27 Aug. 2006. 25 Aug. 2010. <http://query.nytimes.com/gst/fullpage.html?res=9A04EFD8103EF934A1575BC0A9609C8B63&scp=1&sq=Pension%20Fund%20Short%20or%20Full?%20Depends%20on%20the%20Evaluator&st=cse>

[90] According to the most recent Complete Annual Financial Reports from the five public pension funds that make up New York City's pension system.

[91] Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 87 Employers' Accounting for Pensions, 2008.

[92] See Girard Miller, "New Proposal for Pension Books." *Governing*. (20 May 2010), available at: http://www.governing.com/columns/public-money/new-gasb-proposals-pension-bookkeeping.html.

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In short, private sector standards would drive substantial revisions in the Fund's stated assets and liabilities and paint a very different, but more accurate, picture of its financial health.

Fortunately, change is coming. GASB is currently conducting an extensive review of its policies, including a number of the key issues raised here. Some of the considered changes can be previewed in a GASB document entitled "Preliminary Views of the Governmental Accounting Standards Board on major issues related to Pension Accounting and Financial Reporting by Employers," No. 34P (June 16, 2010).[93] For these changes to take effect, GASB must first consider public comment on the proposals, in accordance with Federal Administrative Law. If GASB does the right thing and adopts the fairer standards of its FASB cousin (though the Preliminary Views statement suggests they will only partially do so), we will have truth in public pension accounting for the first time, and our public officials will no longer be able to hide our pension crisis from wider view.

Not surprisingly, but embarrassingly nevertheless, many state pension fund officials, including the New York State Comptroller, have taken this opportunity to write to GASB officials and urge them not to make any material changes in its oversight practices and are opposing alterations to its rules.[94] This is the equivalent of Enron writing to the FASB and requesting that they not change the accounting rules governing the special purpose entities that were a factor in its ultimate demise. Meanwhile, *The Wall Street Journal* reports that the proposed GASB reforms are popular among "government bond buyers, civic groups and others who use the financial information presented by local governments" and others who may be harmed by misleading representations of state financial obligations.[95] Evidently, public pension officials fear truth in accounting and accepting the standards under which corporations must operate.

Anticipated changes go beyond those of GASB. In January 2010, the SEC announced that it had a special unit investigating public pension disclosures. The first public action of this initiative resulted recently in an accusation of securities fraud against New Jersey, the first ever against a state, and a settlement. Further SEC action is anticipated.[96]

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[93] Available at: www.gasb.org/cs/ContentServer?c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176156938122 ("Jun. 16 Preliminary Views")
[94] Chon, Gina. "Gurus Urge Bigger Pension Cushion." *The Wall Street Journal*. 29 Mar. 2010. 25 Aug. 2010. <http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748703416204575146213238489720.html>
[95] *Ibid*.
[96] Walsh, Mary Williams. "Pension Fraud by New Jersey is Cited By S.E.C." *The New York Times*. 18 Aug. 2010. 31 Aug. 2010. <http://www.nytimes.com/2010/08/19/business/19muni.html>

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While our nation's pension underfunding crisis may be massive, regulatory changes and public pressure will bring the game to an end soon, and New York must begin to prepare for these changes today.

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VII. What Does It All Mean? How Big is Our Problem?

To summarize the impact of private sector standards, consider the following:

- There is a reasonable range of appropriate discount rates for public pension funds, though New York's chosen rate is far outside this range.
- There is a reasonable range of investment return expectations for public pension funds, though New York's current return assumption is also outside this range.
- The Comptroller does not provide enough transparency for outsiders to calculate the impact of valuing assets at their *current* market values (only historical values) or to calculate the impact of revised amortization standards, though we know the latter would certainly exacerbate the underfunding by increasing liabilities, and the former likely would as well.

Even before factoring in the affects of mark-to-market valuation and shorter amortization schedules, private sector standards (i.e., a discount range of around 4% to 6%) would reveal a pension deficit for New York State ranging from about $30 billion to $80 billion.[97]

This analysis should make clear that public pension funds are the next great Ponzi scheme likely to blow a hole through the American economy, and the politicians in charge of them are covering it up through lax accounting standards that hide the size of the crisis.

The enormity of this calls to mind the structured investment vehicles (SIVs) that helped nearly sink some Wall Street banks, most notably Citibank. These SIVs allowed investment banks to take advantage of current accounting rules and keep certain assets and debts "off-balance sheet," to the point where even highly sophisticated senior executives and board members misunderstood the risks.[98] However, once investors learned of the size of the problems, they created havoc, prompting action. Similarly, Greece's financial position was not understood until a new regime came into power and revealed what had been previously hidden by questionable accounting.

The above are just two of the many financial calamities that were a part of the great credit bubble we lived through in recent years. The credit bubble enabled excess consumption and borrowing by every segment of society—from Wall Street to federal and state governments to consumers.

[97] This analysis relies on the assumption of a 15 year average life for employees.
[98] Dash, Eric. "Big Rescue of Funds by Citigroup." *The New York Times*. 14 Dec. 2007. 31 Aug. 2010. <http://www.nytimes.com/2007/12/14/business/14citi.html?scp=1&sq=big%20rescue%20of%20funds%20by%20citigroup&st=cse>

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It will take years of sacrifice under a long-term plan to repair the damage, but the only alternative is to follow the course of Japan, which refused to deal with the fallout from its own credit bubble in the 1980s and stagnated for decades as a result. For states, the biggest bubble hangover is the coming pension crisis, and we need to be honest about the size of it before it overwhelms us. If we act soon enough, we can still avoid the horrific cataclysms that engulfed those other two segments—but only if we act soon enough.

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VIII. The Right Way to Manage the CRF

Many of our pension issues are rooted in the political considerations that seep into the management of the Fund. To prevent political influence where it is unhelpful, damaging and too often scandalous, New York's pension management is in need of several immediate professional reforms. At the core of these reforms are changes in the decision-making process of the Fund's trustee.

Sole Trustee: Pros and Cons

New York State's Pension System is one of only three states that employ a sole pension trustee. Much has been said, and for good reason, about the shortcomings of this management structure, including:

1) No one person has a monopoly on wisdom and should not be entrusted with that much authority.
2) The sheer size and breadth of our Pension Fund leads to substantial opportunities for corruption, as evidenced in recent years. Even with an honest Comptroller and senior staff of integrity, the potential appearance of impropriety is significant enough that the appropriateness of a sole trustee must be questioned.
3) The political process does not typically lead to identifying the best stewards of the Pension Fund. Combining an inherently professional role with the electoral process leads to poor results and unqualified Comptrollers.

There are other concerns, but these are the chief arguments for reforming the sole trustee, and why the vast majority of states prefer a fiduciary board.

There are also significant advantages to the sole trustee system, seen most clearly through the failures of public pension systems managed by a board:

1) The sole trustee maintains ultimate accountability. When the Fund performs poorly, the voters know whom to blame, rather than diffusing responsibility among appointed board members.
2) The sole trustee can be an effective bulwark against politically motivated raids on the Pension Fund by profligate politicians who can't balance the State budget. Unfortunately, this longstanding virtue and its tradition in New York has been undermined by the current and most recent Comptrollers, who both proposed, and ultimately got passed, pension raids in the form of borrowing plans.

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3) The sole trustee can bring about effective reform of Fund management more quickly and more professionally than a board. At a time when reform is badly needed, this becomes especially important.

So how does one address the major shortcomings of the sole trustee system while retaining its virtues?

Mend it, Don't End it

A thoughtful reform approach would preserve the strengths of the sole trustee and correct its major shortcomings.

To do this, the entire approach to investing the Fund should be changed. Most significantly, the Comptroller should create a true investment committee of 7 to 9 retired, world-class investors. New York State has more investment talent than any other state or even any country in the world, yet we barely utilize it. The current Investment Advisory Committee is hardly utilized for key investment decisions and has suffered a number of defections. A proper investment process would create a world-class investment committee and also utilize it far more extensively, as described below. This is not a novel concept—it is, in fact, the way the vast majority of successful investment organizations are managed, and the Fund would do well to adopt the same common-sense approach.

It is important to note the distinctions between this Investment Committee and the boards that are found at the vast majority of public pension funds. First, none of the appointees would be politically motivated or based on politics; they would be purely merit-driven considerations based on investment talent. By design and execution then, each appointee would possess an extraordinary amount of financial experience. Second, the Investment Committee would be utilized differently than a typical board and as outlined below:

1) Establish asset allocation.
    a. The Comptroller will work with the Investment Committee to revise the asset allocation, within the boundaries established by the Legislature but with dramatically less risk in the portfolio. The Comptroller will retain the ultimate authority on the final asset allocation, but it will be developed through extensive discussions with and review by the Investment Committee.
    b. Recent stewardship of the State Pension Fund is a lesson on the perils of an overly aggressive return assumption: by shooting too high, the Fund took on too much risk, which led to more volatility and underperformance. Here, it's interesting to

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note that in the 1980s, before inflation and market bubbles enticed public pension funds into equities in far greater proportions, most were invested primarily in treasuries, corporate bonds and other less risky assets and had a correspondingly lower investment return assumption, generally around 4% to 5%.[99] One way to think about that history is that public pension funds for decades were invested conservatively, had little volatility and delivered on their promises, even in adverse market environments. The long bull market from 1982 to 2000 allowed for pension funds to take on more risk, make richer promises and get away with it. It has taken the better part of a decade of mediocre market returns for the sins of the bull market period to catch up with us, but the overall trend among public pension fund returns has been clear enough. The corresponding costs have proven to be massive.

Interestingly, over the last three years, the most conservative part of the portfolio, the fixed income portfolio, was far and away the best performing portion of the Fund (a 6.8% compound annual return over the past three years, when overall performance was negative). Had the current Comptroller established a 6% investment return assumption at the beginning of his tenure and shifted more assets into fixed income, the Fund would have performed much better, with less risk, than it actually did, and taxpayers would be much better off.

2) Equities and Fixed Income Investments
    a. The asset allocation process will likely result in a meaningful shift from equities to fixed income. Still, within each asset class, there is a second layer of decisions to be made: what is the appropriate mix of active vs. passive (index fund) management?
    b. The vast majority of active managers underperform the index after fees over time.
        i. For example, the below chart illustrates the net rate of return over the last 1, 3, 5 and 10 years, for actively managed funds in New York's pension portfolio and the net rate of return for the S&P (passively managed funds would do approximately 0.20% worse than the S&P due to fees). As these results consistently show, active managers selected for the Pension Fund perform materially worse, on average, after fees than a passively managed index.

[99] National Association of State Retirement Administrators. "Public Pension Plan Investment Return Assumptions." NASRA Issue Brief March 2010. 25 Aug. 2010. 3. <http://www.calpersresponds.com/downloads/NASRA_InvReturnAssumption%20acrobat5compatible.pdf>

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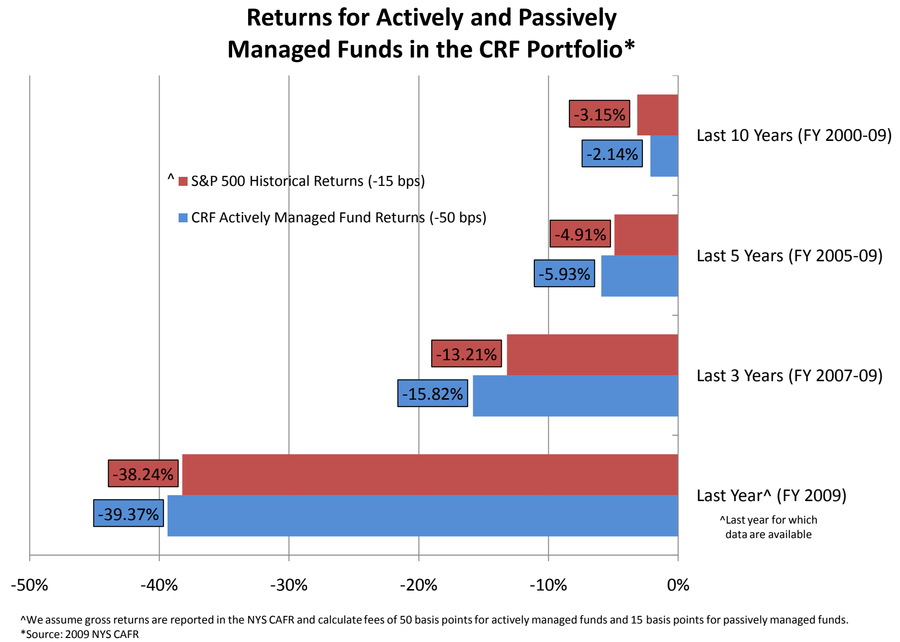

- ii. This is not to say that active management should be abandoned—rather, that the Comptroller should select active managers in a manner different from current practice, namely:
  1. Only select managers who can generate true alpha, or outperformance relative to the market, net of fees. This is highly likely to lead to a reduced number of active managers in the portfolio, increasing the percentage of equities currently under passive management (78%)[100] while reducing the overall fees currently paid to equity fund managers ($98.8 million).[101]
  2. Utilize the Investment Committee's expertise to do so.
- iii. In fact, it is with the selection of active managers that most of the opportunity for ethical impropriety, or at least the appearance of impropriety, develops. To eliminate this problem, the Comptroller and the Investment Committee should operate as a "double veto" system for the

[100] Office of the State Comptroller, New York State and Local Retirement System. "2008 Comprehensive Annual Report." Albany, NY, 2010. 58 <http://www.osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_08.pdf>

[101] Office of the State Comptroller, New York State and Local Retirement System. "2008 Comprehensive Annual Report." Albany, NY, 2010. 51. <http://www.osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_08.pdf>

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selection of any active manager. When the staff makes a recommendation to hire an active manager, that recommendation must first be presented to the Investment Committee. Only if the recommendation is approved by the Investment Committee can it be reviewed by the Comptroller, who also has the ability to approve or decline. For an active manager to be selected, then, the manager must first be approved by the Investment Committee, then the Comptroller—a double veto system.

3) Alternatives (Private Equity and Hedge Funds):
    a. Just as in the case of more traditional equity and fixed income active money managers, most private equity funds and hedge funds do not outperform the market, net of fees and particularly on a risk-adjusted basis (i.e., adjusting for the fact that certain, but not all, firms employ leverage and thus have greater risk associated with their strategies and their returns). Similarly, then, the Comptroller must only invest in alternative managers who can generate true alpha and who pass through the double veto system. This approach is highly likely to lead to a reduced number of active managers in the portfolio, as well as reduced fees paid by the Fund. Presently, the New York State Pension System pays over $175 million annually in management fees to private equity and hedge funds.[102]
4) Direct Investments, including Real Estate:
    a. Direct investments and real estate pose special challenges—they present all of the conflicts inherent in active manager selection but also require greater in-house expertise in order to properly diligence the opportunity, assess the risks, etc.
        i. In one of the better practices of the current Comptroller, he utilizes a more active advisory committee for real estate investments as a partial recognition of this special case
    b. However, in a much more professionalized investment process, there is an opportunity for a modest amount of direct investment in partnership with private investment funds that bear the same risk that the Fund would bear.
    c. These investments should be subject to strict limits and in all cases will constitute a small proportion of the portfolio.
    d. All such investments would have to go through the same double veto system, with a separate Investment Committee for real estate investments.
5) Staff.
    a. Under a substantially more professional operation, the investment staff of the Fund will follow a more clearly defined investment process, complete with robust

[102] *Ibid*.

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investment memoranda laying out the rationale for an investment and periodic portfolio reviews to test whether the investment case has borne out or must be revisited. Well-managed investment organizations consistently and universally follow such disciplines, and professionalizing the management of the Fund will lead to greater accountability, greater results and an improved investment culture that will benefit Fund members, retirees, beneficiaries and employees.

The above structure blends the benefits of the sole trustee system (principally, creating a bulwark against the politicization of the Fund while preserving accountability to the electorate) with the *intended* benefits of a board (principally, broader decision-making and input, greater transparency to guard against mistakes of judgment and ethical breaches) that are too often not realized in practice (witness the many abuses at CalPERS, the City of San Diego, Ohio and Illinois).[103] The institutionalized dynamic also ensures that the Comptroller receives and deliberatively considers the best investment guidance available, while maintaining political independence. This arrangement can help ensure strong risk-adjusted returns as well as protections from ethical lapses and raids from politicians who scheme to use the State's Pension Fund to make up for the consequences of their own profligate spending. This improved process of enhanced due diligence and analysis should also lead to a reduction in the almost $350 million that the current Comptroller's office spends on management fees to Wall Street and other outside investment firms.[104]

[103] Walsh, Mary Williams. "Ex-Chief of S.E.C. Says Pension Funds in Danger." *The New York Times*. 31 Oct. 2007. 25 Aug. 2010. <http://www.nytimes.com/2007/10/31/business/31sec.html>
[104] Office of the State Comptroller, New York State and Local Retirement System. "2008 Comprehensive Annual Report." Albany, NY, 2010. 51. <http://www.osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_08.pdf>

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IX. Anticipating the Critiques

Critique #1: The Pew Center on the States and Governing Magazine say that New York has "the best-managed public pension fund in the nation."

This is categorically false. Both the Pew Center[105] and *Governing Magazine*[106] say that New York State is the *best funded* (but stay tuned) public pension plan in the country, not the best managed. In fact, the New York State Pension Fund is neither well-funded nor well-managed:

1) In the case of both the Pew Center and *Governing Magazine*, neither makes an independent judgment on funding levels. Both take New York's own reported ratios at face value. [107] They don't prepare a robust comparison of the accounting practices among states, don't question whether those accounting practices are appropriate or reveal much else that shows significant independent analysis. In effect, Pew and *Governing Magazine* are merely repeating the New York State Comptroller's own problematic claims built on accounting gimmicks.
    a. Pew and *Governing Magazine* risk being accomplices to the great public pension Ponzi scheme. To avoid that ignominy, they should highlight the issues described herein and use them to compare fund practices so that investors and taxpayers know the truth about our country's public pensions.
2) "Well-managed" could mean a range of different things, but, for an investment fund, most fundamentally it comes down to performance. Interestingly, the Comptroller has cited relative performance for the Fund as recently as May 2009,[108] but, to the best of our knowledge, that disclosure mysteriously ended as the Fund's performance fell below the median for the Comptroller's tenure. In short, the Fund's performance over the last year, last two years and last three years has lagged the median performance of public pension funds tracked by R.V. Kuhns & Associates.

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[105] The Pew Center on the States. "The Trillion Dollar Gap." February 2010, pp. 56. <http://downloads.pewcenteronthestates.org/The_Trillion_Dollar_Gap_final.pdf>

[106] Kim, Andy and Kerrigan, Heather. "Pension Preparedness." *Governing Magazine*. August 2010. 23 Aug. 2010. <http://www.governing.com/topics/public-workforce/pensions/pension-preparedness.html>

[107] Pew Center on the States. "The Trillion Dollar Gap," February 2010. 23 Aug. 2010. 53. <http://downloads.pewcenteronthestates.org/The_Trillion_Dollar_Gap_final.pdf>
Kim, Andy and Kerrigan, Heather. "Pension Preparedness." *Governing Magazine*. August 2010. 23 Aug. 2010. <http://www.governing.com/topics/public-workforce/pensions/pension-preparedness.html>

[108] Office of the New York State Comptroller. "New York State Pension Fund Declines 26 Percent." Press release, 30 May 2009. <http://www.osc.state.ny.us/press/releases/may09/052909.htm>

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Of course, as stated earlier, the real benchmark for a public pension fund is its investment return assumption, as performance short of that goal triggers tax increases, and, in the last three years, the Pension Fund has underperformed that benchmark by nearly $50 billion.

Critique #2: Reducing the investment return assumption will trigger tax increases.

This argument is the height of hypocrisy: The current Comptroller enables a colossal pension problem, we blow the whistle on it, and he blames the whistleblower. The underlying economics make clear that our State Pension Fund is substantially underfunded. Dealing with that will force some very hard choices. But the first step to dealing with a problem is being honest about the size of it, which the current Comptroller refuses to do.

Ironically, recent press reports suggest that the Comptroller is actually considering some changes to his current practices. After months of defending the current 8% return assumption in the face of pressure from us and others, the Comptroller is reportedly planning to reduce the investment return assumption to 7.5% or 7.75%.[109]

While our proposals and policies highlight the true magnitude of our pension deficit, it is our firm view that New Yorkers cannot afford higher taxes. On the contrary, the entire reason we are waging this campaign is to use the full powers of the Comptroller's office to cut spending and force fiscal discipline, including tax cuts, to benefit New Yorkers from all walks of life. A lower overall tax burden, particularly for working class and middle class New Yorkers, is the only way in which New York can attract businesses and jobs and grow its economy.

Having identified the true extent of our pension deficit, our prescribed course of action is to work with the Governor and the Legislature on a long-term plan to bring our Fund back to solvency at an acceptable cost to taxpayers and without any increase in taxes. We must honor our obligations to government workers, but we must not increase New Yorkers' tax burden. The way to achieve this is through meaningful pension reform over a long period of time.

Critique #3: The Pension Fund is not a hedge fund; it is invested for the long-term. Markets rebound over time, and we shouldn't change policy simply because we went through a tough period in the equity markets.

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[109] Scott, Brendan. "Low pension return may $oak taxpayers." *New York Post.* 21 Aug, 2010. 25 Aug. 2010. <http://www.nypost.com/p/news/local/low_pension_return_may_oak_taxpayers_sF9oJEnk8ySpdJwM6fPqWL>

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When the Comptroller and his staff make this argument, it reveals an unsettling ignorance about investment management and calls to mind the former Governor's characterization of Mr. DiNapoli as "thoroughly and totally unqualified." Our argument for reducing the risk in the portfolio has nothing to do with recent equity market underperformance and everything to do with this simple question: given the nature of the Fund's liabilities (i.e., constitutionally protected), what is the appropriate long-term risk profile for the assets? If the liabilities (benefit payments) are guaranteed, then the investments must be managed in a low-risk way. Otherwise, we develop the financial difficulties that continue to mushroom and threaten public pensions nationwide.

Critique #4: Now is not the time to switch policies. We need to maintain the policies of Mr. DiNapoli, who is tested and trusted, rather than switch to a risky new approach.

The Pension Fund is woefully underfunded and has achieved investment returns below the median for public pension funds for the last year, last two years and last three years—all of Mr. DiNapoli's tenure. The Fund's underperformance relative to its unrealistic benchmark, which could have and should have been revised downward, has cost New York taxpayers nearly $50 billion.

By contrast, our approach dramatically reduces the risk in the Pension Fund. In effect, it makes it a boring asset—which, considering it provides constitutionally protected benefits to retirees, is exactly what members, retirees, beneficiaries and taxpayers should want it to be. Pensioners, current members and taxpayers deserve a "boring asset" that doesn't impose higher taxes on them because a politician thought he could make up for shortfalls with risky investment strategies.

Critique #5: The last several Comptrollers have been politicians, not professionals. Why isn't Mr. DiNapoli's background appropriate, given that history?

We live in far more financially perilous times now than we have at any point in the last 30 years, and this turmoil argues for a professional financial steward. A key driver of rising pension costs is their arcane, complex nature and the consequent timidity or even ignorance with which traditional politicians address them. We believe that the Comptroller must have the requisite experience to understand, address and be able to reform these issues in the most effective way.

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We also believe that the members of the Investment Committee should be world-class investment professionals possessing at least one of the following:

a) A CPA from an accredited university;
b) An MBA from an accredited business school; and
c) At least 10 years of finance or accounting experience.

There is precedent for this approach. The Mississippi Public Employee Retirement System conducted a survey of other state systems on behalf of the National Association of State Retirement Administrators and found that about 36% had a formal education policy for its pension board members, 24% had mandatory educational requirements and at least one other had a mandatory certification program.[110] Similarly, the Sarbanes-Oxley Act of 2003 strongly urges that the audit committee of a public company contain at least one "financial expert," or disclose the fact that it does not. Just as Sarbanes-Oxley sought to deal with Enron-type abuses by ensuring that corporate audit committees contained financial expertise, the Fund should have the same requirement.

Of course, if those are the requirements for a position on the Investment Committee, one may wonder whether they should also be requirements, either in law or in practice, for the Comptroller as well. No reasonable New Yorker would hire a politician to manage his or her own retirement account. Why would we elect someone with no financial background to be New York's chief fiscal officer?

Critique #6: Over the last twenty years, the Fund has returned in excess of 8%, so an investment return assumption of 7.5% to 8% is achievable, even conservative.

We examine this at length in our discussion of investment return assumptions, but the best critique rests on two factors:

1) Outside of pension funds, which have an incentive to inflate return expectations to grant greater benefits today at the expense of future taxpayers and aren't hemmed in by more prudent accounting standards, few responsible investors assume an 8% long-term rate of return, or, more importantly for the purposes of calculating funding ratios, would apply an 8% discount rate to liabilities that are constitutionally protected.

[110] National Association of State Retirement Administrators. "Board Education Survey." November 2005. 25 Aug. 2010. <http://www.nasra.org/resources/Board%20education%20and%20travel%20policy.pdf>

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2) The performance over the last twenty-plus years is a tale of two cities—the great bull market of the late 1980s and 1990s, including the impact of the dot-com bubble, and the more challenged markets of this decade, with Fund returns to date below 5%. Virtually all experts believe that the anomaly in this history is not the past decade, but the long bull market of the late 1980s and 1990s, leaving a period that incorporates that history a poor gauge for future results.

X. Key Takeaways

Note: footnotes for these summary points appear previously in this document.

- A series of recent studies reveal that a proper accounting of our nation's public pension funds reveals an underfunding of approximately $3 trillion.
  - The cost to taxpayers for the savings and loan crisis was $124.6 billion. The estimated cost to taxpayers for the Troubled Asset Relief Program (TARP) ranges from $109 to $127 billion. The bailouts of Fannie Mae and Freddie Mac are projected to be $389 billion. These figures, massive as they are, pale next to the gathering storm of America's underfunded public pensions.

- A similarly honest accounting of New York State's pension assets and liabilities would reveal a substantial underfunding of between $30 billion to $80 billion.

- The costs to New York State of its Pension System are skyrocketing.
  - In fiscal year 1998, New York spent almost $3.5 billion on member benefits. By fiscal year 2008, New York spent over $7 billion, an increase of over 100%.
  - The rise in the financial cost for everyday New Yorkers has been similarly meteoric.
    - Over the last decade, taxpayers' annual pension contributions increased from $245 million to $1.7 billion, and the ratio of taxpayers' contributions to employee contributions has grown to roughly $10 to $1.

- Under the current Comptroller, the Fund's investment returns have been significantly below the median of other comparable public pensions for the last year, the last two years and the last three years and have further exacerbated New York's pension shortfall.
  - In fiscal year 2010, for example, when the State Comptroller's office announced with fanfare that the Fund achieved returns of 25.90%, the Comptroller

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dramatically underperformed the median return of 32.86%—a miss of nearly $8 billion that is being passed on to taxpayers.

- In the prior fiscal year, the Comptroller lost 26.38% of the Fund's value and has had negative overall performance over the past three years.
  - The Fund's cumulative underperformance, relative to its 8% target investment return, over the past 3 years totals nearly $50 billion.

- To cover up the tax increases triggered by the Fund's underperformance, the current Comptroller devised a scheme to limit near-term pension contributions and kick the can down the road past the election.
  - The plan has been labeled a borrowing plan by every major news organization to cover it, despite the Comptroller's transparent protests to the contrary.
  - In just the first six years, the plan would allow the State and local governments to borrow up to $10 billion, which would carry future interest costs in excess of $3 billion.
  - The overall cost of this scheme is devastating as the bill that ultimately passed the Legislature allows for this foolhardy borrowing to go on indefinitely, without a proper accounting of its costs.
    - The costs to New York's overtaxed families will be overwhelming. Under an earlier version of the plan that limited borrowing to six years, pension-related costs for New York households outside of New York City would have increased by $1,300/year by 2017. Instead, the plan that was approved increases the costs by delaying the day of reckoning.
    - In short, it is a Ponzi scheme that will eventually collapse. To illustrate just one of the incredible risks of this plan, it reportedly relies on fanciful market assumptions that repeat the market conditions after 1987, including the halcyon years between 1988 and 1998 when returns averaged nearly 14%.
      - If the unrefuted reports are true, for the Comptroller's market assumptions to hold up, the Dow would need to reach 80,000 by 2022.

- Lax government accounting standards set by GASB allow politicians to hide public pension deficits.

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- GASB allows public pensions to choose a target return rate on fund investments and a corresponding discount rate without consideration of market risk.
    - As a result, riskier investments translate into higher return expectations and higher discount rates, perversely reducing the present value of pension liabilities.
        - This has no grounding in basic economics, finance or common sense and is not allowed for any private sector entities or nonprofits, but it is a fundamental foundation of public pension accounting.
    - The New York State Comptroller has taken advantage of GASB's twisted logic and increased the State Fund's exposure to alternative assets, such as private equity firms and hedge funds, resulting in fees to alternative asset funds of approximately $200 million, while he simultaneously blames them for contributing to our nation's economic collapse in a cynical election year ploy.
        - Over the last three years, the most conservative part of the Fund's portfolio—fixed income—was far and away the best performing asset (a 6.8% compound annual return over the past three years, when overall performance was negative).
            - Had the Comptroller established a lower, more realistic investment return assumption at the beginning of his tenure and accordingly shifted more assets into lower-risk assets, the Fund would have performed much better, with less risk, and taxpayers would be much better off today.
            - Instead, he defended his 8% return assumption for months, after being criticized by us and others, and then recently reversed himself to indicate he is considering a modest, but insufficient, move downward.

- GASB also allows public pensions to use a variety of accounting gimmicks to restate their asset values, and New York's Pension Fund uses an "actuarial asset value" that incorporates two devices that have little relation to the market value of assets.
    - First, asset values are smoothed out over a five year horizon. So, if the Fund owns stock in Microsoft, and Microsoft trades on the stock exchange at $25.00 per share, the actuarial value of Microsoft at that time could be $20, $30 or some other number that reflects a five-year smoothing.
    - Second, a component of the actuarial asset value allowable by GASB includes the present value of future State and local government contributions (paid for through state and local taxes) and contributions by employees.

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    - Due to this provision, as long as the Fund is willing to stipulate that it will always pass through pension fund shortfalls to the taxpayers and has a robust mechanism to do so, it will always *appear* fully funded. In other words, the Comptroller's contention that the Fund is fully funded is nothing more than a combination of accounting gimmicks and a rock-solid assurance that he will pass through underperformance to the taxpayers—claiming credit for fully-funded status on the backs of New York's beleaguered taxpayers.
  - Our ability to assess the impact of mark-to-market asset valuation is hamstrung by the limited transparency provided by New York's Comptroller.
    - But a recent example of a public pension system performing such a valuation is telling.
      - For 2008, New York City's chief actuary calculated the mark-to-market value of assets in the five funds that make up the City's Pension System and revealed a $45 billion funding deficit compared to the "fully funded" status that the more misleading, GASB-approved accounting method reported

- The New York State Comptroller also assumes a fanciful 8% rate of return on Fund investments.
  - A *sustainable* long-term rate of return for a pool of assets as large as the State Pension Fund is likely closer to 6%, perhaps less. Further, since taxpayers are on the hook for shortfalls, a proper fiscal watchdog would err on the side of caution.
  - Historical returns that include the great bull market of the late 1980s and 1990s are a poor guide, as the conditions that led to that anomalous performance are unlikely to be repeated. Further, the vast majority of professional investors believe that the longer-term view of market performance needs to be adjusted downward to account for the U.S.'s more mature economy and long-term structural challenges.
  - Warren Buffet, among the most successful investors in the world, assumes a long-term rate of return for his Berkshire Hathaway pension assets of 6.9% and has argued that equity returns of 6% are a more reasonable long-term assumption.
    - What does Tom DiNapoli know that Warren Buffett doesn't?

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- This analysis should make clear that public pension funds are likely to blow a hole through the American economy, and the politicians in charge of them are covering it up through lax accounting standards that hide the size of the crisis.
  - GASB is currently conducting an extensive review of its policies, including a number of the issues raised here.
    - Rather than leading the charge on reform, as the Comptroller of New York State should be, the current Comptroller has instead taken this opportunity to write to GASB officials and urge them not to make any material changes in its oversight practices and is opposing alterations to its rules.
      - This is the equivalent of Enron writing to the SEC and requesting that they not change the rules governing the special purpose entities that were a factor in its ultimate demise.

In dealing with New York's pension underfunding, the State and its leadership must adhere to three bedrock principles:

1. The true extent of our shortfall must be made clear through honest accounting.
2. New Yorkers cannot afford additional taxes, so <u>increased taxes cannot be a part of any solution.</u>
3. The promises already made of New York's government workers, retirees and their beneficiaries are to be provided for in full.
   - Given the limited levers left, the reality is that the Comptroller will need to work with policymakers to develop a long-term restructuring plan that is consistent with these principles, yet brings the Fund back to fully funded status over time. Such a plan will by necessity require a Tier VI for new employees.

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XI. Conclusion

In this white paper we have examined the nature of New York's own pension crisis in order to expose its magnitude. The first step must be to acknowledge we have a significant problem and to try to determine the size of it.

The next step is an open dialogue among pension stakeholders on how to address our crisis. New or higher taxes in any form should be ruled out. Since New Yorkers already bear the highest state and local tax burden in the nation, and this burden continues to drive out businesses, jobs and people that are vital to the State's tax base, additional or increased taxes are simply unaffordable. The coming tax hikes created by the Fund's underperformance under the current Comptroller must be mitigated or avoided to the fullest extent possible. It is also fundamentally unfair to ask overtaxed citizens to rectify the mistakes of imprudent politicians who did not properly consider the costs of their campaign promises or execute their responsibilities effectively.

As for solutions, the opacity of information makes it difficult to articulate the full set of options that remain. The only proper way to solve this problem is to conduct a full-blown analysis of future liabilities, apply appropriate valuation and accounting standards and then create a long-term plan by working with elected leaders and stakeholders to bring the Fund back to the fully funded status that members, retirees, beneficiaries and taxpayers all deserve. There are some areas which we can identify now, however, and we would pursue the following plan of action in order to help save New York taxpayers from the coming economic and tax disaster:

a) Apply private sector accounting standards to uncover the true size of our problems. The shortfalls, created by years of mismanagement, cannot be fixed overnight. The Comptroller must work with the Governor and the Legislature to address its problems over time. This begins with the creation of a Tier VI benefit plan that curbs abuses like pension padding and double dipping and reflects financial realities. Tax increases to support pension problems are unacceptable. We will do whatever possible to curb or eliminate the current tax increases projected by the State Comptroller today.
b) Establish target returns and asset allocations that will incorporate less risk, less active management, reduced fees and less volatility. Our members, retirees and beneficiaries deserve a well-managed Pension Fund that will be able to honor all of our obligations.
c) Fight, with every power at our disposal, any efforts to borrow from the Pension Fund, and do everything possible to mitigate the tax impact from recent mismanagement.

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d) Immediately bring in outside expertise to improve the current investment decision-making but preserve the sole trustee's accountability and independent powers to protect the Fund from raids.
e) Combine these efforts to professionalize the Pension Fund with our earlier ethics reform proposals to create the most effective and transparent public fund in the nation.