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COSTLY PROMISES

Public Pension Plans Face Billions in Shortages

By MARY WILLIAMS WALSH

In 2003, a whistle-blower forced San Diego to reveal that it had been shortchanging its city workers' pension fund for years, setting off a wave of lawsuits, investigations and eventually criminal indictments.

The mayor ended up resigning under a cloud. With the city's books a shambles, San Diego remains barred from raising money by selling bonds. Cut off from a vital source of cash, it has fallen behind on its maintenance of streets, storm drains and public buildings. Potholes are proliferating and beaches are closed because of sewage spills.

Retirees are still being paid, but a portion of their benefits is in doubt because of continuing legal challenges. And the city, which is scheduled to receive a report today on the causes of its current predicament, still has to figure out how to close the $1.4 billion shortfall in its pension fund.

Maybe someone should be paying closer attention in New Jersey. And in Illinois. Not to mention Colorado and several other states and local governments.

Across the nation, a number of states, counties and municipalities have engaged in many of the same maneuvers with their pension funds that San Diego did, but without the crippling scandal — at least not yet.

It is hard to know the extent of the problems, because there is no central regulator to gather data on public plans. Nor is the accounting for government pension plans uniform, so comparing one with another can be unreliable.

But by one estimate, state and local governments owe their current and future retirees roughly $375 billion more than they have committed to their pension funds.

And that may well understate the gap: Barclays Global Investments has calculated that if America's state pension plans were required to use the same methods as corporations, the total value of the benefits they have promised would grow 22 percent, to $2.5 trillion. Only $1.7 trillion has been set aside to pay those benefits.

Not all of that shortfall, of course, is a result of actions like those that brought San Diego to its knees. And few governments have been as reckless as San Diego officials in granting pension increases at the same time as they were cutting back on contributions.

Still, officials in Trenton have been shortchanging New Jersey's pension fund for years, much as San Diego did. From 1998 to 2005, the state overrode its actuary's instructions to put a total of $652 million into the fund for state employees. Instead, it provided a little less than $1 million. Funds for judges, teachers, police officers and other workers got less, too.

To make up the missing money, New Jersey officials tried an approach similar to one used in San Diego. They said they would capture the “excess” gains they expected the pension funds’ investments to make and use them as contributions.

It was a doomed approach, leaving New Jersey to struggle with a total pension shortfall that has ballooned to $18 billion. Its actuary has recommended a contribution of $1.8 billion for the coming year, but the state has found only $1.1 billion, so it will fall even farther behind.

Illinois also duplicated one of San Diego’s pension mistakes. It tried to make its municipal pension plan cheaper by stretching its funding schedule over 40 years — considerably longer than the 30 years that governmental accounting and actuarial standards permit, and more than five times what companies will get under a pension bill that has just passed Congress.

Illinois is stretching its pension contributions over 50 years. At that rate, many of its retirees will have died by the time the state finishes tapping taxpayers for their benefits.

Colorado does not meet the 30-year funding guidelines, either. “At the current contribution level, the liability associated with current benefits will never be fully paid,” the state said in its most recent annual financial report.

Many officials dispute the suggestion that their pension plans are less than sound. The director of the New Jersey Division of Pensions and Benefits, Frederick J. Beaver, wrote recently that “our benefits systems are in excellent financial condition.”

Illinois officials say the state's 50-year schedule is actually an improvement; before adopting it in 1995, the state had no funding schedule at all. In Colorado's most recent legislative session, lawmakers enacted pension changes that they hope will make the plan solvent in 45 years.

And the National Association of State Retirement Administrators says it is unrealistic to expect all public plans to be fully funded, because they do not have to pay all the benefits they owe at once.

Still, the lack of a national response to what would seem to be a nationwide problem underscores a peculiarity of the public pension world: like banks and insurance companies, the pension plans are large and complex financial institutions, but they face no comparable systems of checks and balances.

"There's no oversight; there's no requirements; there's no enforcement," said Lance Weiss, an actuary with Deloitte Consulting in Chicago who advised Illinois on its pension problems. "You're kind of working off the good will of these public entities."

Experts do not think that is good enough.

In January, the board that writes the accounting rules for governments announced that it was looking for ways to tighten the rules for public pensions.

In July, Senators Charles E. Grassley and Max Baucus, the Republican chairman and the ranking Democrat on the Finance Committee, asked the Government Accountability Office to investigate the financial condition of the nation's public pension plans.

In some states, lawmakers have been trying to stop some of the more egregious pension practices that have come to light. Illinois, Louisiana and Nebraska passed laws making it hard for employees to "spike" pensions higher by manipulating their salaries. Because pensions are often based on a worker's final salary, workers have found ways to credit one-time bonuses to their last year and reap a lifelong reward. Arizona required that early retirement programs be paid for up front.

And today in San Diego, a former chairman of the Securities and Exchange Commission, Arthur Levitt Jr., is scheduled to issue a long-awaited report on the years of pension lapses that got the city into its current predicament.

Mr. Levitt is not tipping his hand on his findings. But given the activist stance he took on cleaning up the municipal securities markets as S.E.C. chairman, it would be no surprise if he called for tighter control over a sector where the amounts of money are huge and the amount of oversight is small.

The city of San Diego hired Mr. Levitt's three-man audit team in February 2005, after the city's outside auditor, KPMG, would not sign off on its accounts.

He is working with the S.E.C.'s former chief accountant, Lynn E. Turner, and Troy Dahlberg, a managing director in the forensic accounting and litigation consulting practice of Kroll Inc., the investigative firm that is a unit of Marsh & McLennan Companies.

Public plans are not governed by the federal pension law, the Employee Retirement Income Security Act, that companies must follow. They are not covered by the Pension Benefit Guaranty Corporation, so if they come up short, they must turn to the taxpayers.

Instead, they are governed by boards that often include municipal labor leaders, whose duty to represent their workers' interests can easily conflict with their fiduciary duty to represent the plan itself. And even the most exemplary pension boards can be overruled, in many cases, by politicians whose priorities may be incompatible with sound financial management.

"When the state runs into financial trouble, pension contributions are something that they can defer without, quote-unquote, hurting anybody," said David Driscoll, an actuary with Buck Consultants who recently helped Vermont come up with a plan to revive its pension fund for teachers. Politicians shortchanged it every year for more than a decade.

"In fact, they are hurting people, and the people they are hurting are the taxpayers, who, whether they realize it or not, are going into a form of debt," Mr. Driscoll added. "Those pension obligations don't get cheaper over time. They get more expensive."

Eventually the cost gets too big to ignore, as it now has in New Jersey.

Corporate pension funds have plenty of problems of their own. But they are at least required to adhere to a uniform accounting standard, which provides information that investors can use to decide upon stocks to buy and sell. The standards, in turn, are policed by the S.E.C.

Taxpayers have no such help. For municipal plans, the accounting standards are much more flexible, a decision that was denounced, when it was issued in 1994, by the head of the very board that wrote it.

James F. Antonio, chairman at that time of the Governmental Accounting Standards Board, attached a detailed 10-page dissent to the new rule, saying that it “fails to meet the test of fiscal responsibility” because it permitted “an extraordinary number of accounting options” and some governments were bound to choose the weakest one. Mr. Antonio has since retired.

Even though the governmental accounting board has now begun the slow process of improving the standard, it is unlikely to come up with the level of detailed disclosure required of corporations. And the board, with a full-time staff of just 15, has no authority to enforce its rules.

San Diego violated the rules for a number of years, using accounting techniques that hid both its failure to put enough money behind its pension promises and the debt to its workers that was growing every year as a result.

Several times, the city asked the government accounting board to make a special exception and approve its unorthodox pension calculations, but the board rebuffed it.

But the accounting board was forced to look on in silence as San Diego issued reassuring financial statements, because its charter bars it from issuing public pronouncements on individual cities.

San Diego might have gone on unchallenged indefinitely if not for the decision of one of its pension trustees, Diann Shipione, to blow the whistle, eventually forcing the city to correct the financial disclosures it had made in connection with an impending bond sale. Only then was it possible to see in one place what had been going on with the pension fund. And only then did the S.E.C. get involved.

The Depression-era laws that created the commission gave it no direct jurisdiction over municipal securities; it can pursue municipal wrongdoing only when it finds fraud at work. Lack of complete and accurate disclosure can constitute fraud, but the S.E.C. has only infrequently shown interest in throwing its weight around in the area.

One of those rare instances happened when Mr. Levitt was chairman of the S.E.C., in 1994, after Orange County, Calif., abruptly declared bankruptcy and threatened to repudiate its debts. Mr. Levitt became, as he said at the time, “obsessed” with cleaning up the municipal securities markets.

He created an independent Office of Municipal Securities that reported directly to the chairman; he championed rules to eliminate the pay-to-play practices then commonplace in the municipal bond business; he forced better financial disclosure; and he began an unheard-of number of enforcement actions.

Since Mr. Levitt's departure from the S.E.C. in 2001, much of what he built has been dismantled. The Office of Municipal Securities is down to a staff of two and is no longer independent. The wave of enforcement actions against cities has slowed to a trickle. The S.E.C. investigators who went to work in San Diego after the pension scandal erupted have never said what they found.

When the S.E.C. shifted its gaze away from municipal finance, Mr. Levitt now says, it left "a regulatory hole." If the agency were equipped to monitor state and local governments the way it monitors corporate disclosures, he said, "it could provide an early warning of financial conditions threatening the solvency of any number of communities."