The Debate Over Applying FE Principles to the Funding of Public Pension Plans: A Transition Proposal and Other Ideas

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Comments on Lowman

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This article takes the debate on the applicability of financial economic principles to a new level, showing a real-world potential transition to a system in which the funding target is based on a market value of liabilities (MVL). It is well-accepted that a change from one funding methodology to another would be extremely difficult—if not impossible—to do overnight. Rather, a transition methodology would be necessary.

Keys to a successful transition methodology include allowing a smooth transition as well as minimizing unintended consequences. The proposal this paper suggests does a reasonably good job at developing a transition, as it partitions the plan into legacy and future benefit promises, treating them separately so the plan gradually transitions to an ultimate funding target equal to the MVL as the legacy liabilities become a smaller part of the obligation.

The paper confines itself to funding issues, explicitly noting that it is not addressing other issues such as MVL disclosure. It is important to realize, however, that financial economics itself does not tell us that the MVL be fully funded. As a branch of microeconomics, some of the areas financial economics' (as applied to pension plans) focuses on are appropriate ways to measure pension liabilities and the principle that an unfunded liability is similar to a debt-like obligation. However, financial economics is not the subdiscipline of economics that provides insight into the pros and cons of government debt—it is macroeconomics that provides insight into this issue. As a result, it is plausible to fully believe in the financial economic applications to pension finance, but still not believe that the MVL should be fully funded.

There are, of course, some people whose beliefs in financial economics cause them to support disclosure of the MVL and whose beliefs in macroeconomics cause them to support using the MVL as the funding target. However, a belief in measuring and disclosing the MVL does not require a belief that the MVL should be the funding target. But if those two features are present in a future actuarial system, then the methodology in the article would be a very good starting point for discussions about transitioning.