issues" as the main reason. Another poll finds that 72 percent of the Japanese "don't trust" China—a reasonable position, given not only the territorial disputes, but also Beijing's propensity for deflecting the anger of its restive population of unmarriageable young men by whipping up violent anti-Japanese sentiment.

Back in 2007, then-prime minister Shinzo Abe used the sixtieth anniversary of the ratification of the postwar constitution to call for a "bold review of Japan's postwar stance and an in-depth discussion of the constitution." Abe's tenure lasted less than a year, though, and no constitutional changes were made. Altering the constitution, after all, is hard: It requires two-thirds passage in both houses of the Diet, followed by a successful referendum. Changes are probably unlikely in the immediate future, too, given that Prime Minister Yoshihiko Noda has a moribund economy, a nuclear disaster, and massive post-tsunami reconstruction on the country's northeast coast to deal with.

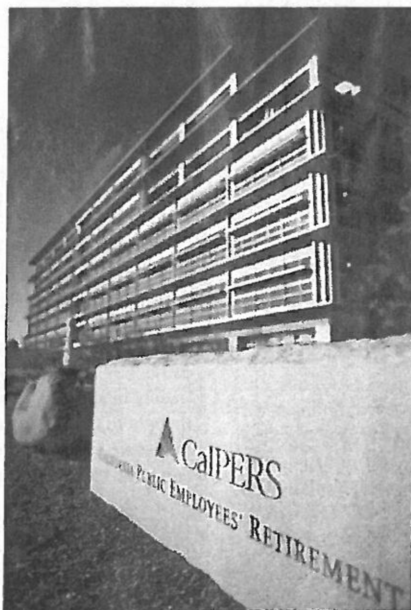
But revisions to Article 9 certainly can't be counted out, especially a few years from now. Given that the Japanese constitution was drawn up under the guidance of the occupying Allies, it doesn't inspire the kind of reverence that, say, the American Constitution does. What's more, experts on Japanese public opinion say that the younger generation is much more nationalistic and much less inclined towards pacifism than previous postwar generations of Japanese.

There is also ample evidence that public opinion is already pushing the national government in a more aggressive direction, even without constitutional changes. This month, some three months after Ishihara's initial provocation, Prime Minster Noda bowed to public pressure and declared that it is now the policy of the national (not just Tokyo) government to purchase the Senkakus. And that Japanese ambassador to China who condemned Ishihara's plan to buy the islands? Members of the Diet have demanded he be fired, and last week he was recalled to Tokyo for "discussions." ♦

California Dreaming

One percent a year returns won't be enough to pay state pensions. BY MARK HEMINGWAY

Last week, California taxpayers, already accustomed to economic doom and gloom, received an astonishing piece of bad news. The California Public Employees' Retirement System (CalPERS) had posted a 1 percent return on its investments over the previous year. The California State Teachers' Retirement System (CalSTRS) didn't fare much better, with a 1.8 percent return. CalPERS and CalSTRS currently have a combined $383.5 billion in assets, making them the largest public pension system in the country.



Maybe we could sell the fancy building.

That's a lot of money, but thanks to California's legendarily generous and corrupt pension programs, the two funds are on the hook for a lot more than they'll be capable of paying out. It's long been known that unfunded state pension liabilities were an acute financial problem, but there's been a raging debate over exactly how big it is—the Pew Center on the States estimates the shortfall nationwide is $757 billion, while a recent report from State Budget Solutions says states are a whopping $4.6 trillion short of covering their obligations.

Mark Hemingway is a senior writer at THE WEEKLY STANDARD.

However, the lower-end estimates, such as Pew's, rely on the states' own assumptions about the likely rate of return on their pension fund investments. For years now, state projections have been divorced from reality. Most states assume a 7.5 percent to 8.25 percent annual return on their investments. By comparison, the S&P index grew at 5 percent a year over the last decade, and many pension fund assets are tied up in more conservative investments than that broad stock market index.

CalPERS' performance is a blow to defenders of states' rosy assumptions. Most states are still loath to admit that the new normal is substantially less than they were betting on—CalPERS, for one, lowered its expectations from 7.75 percent all the way down to 7.5 percent in March (ignoring the advice of its own actuary, who suggested lowering it to 7.25 percent). When New York City's actuary considered a similarly trivial adjustment downwards, Mayor Michael Bloomberg (who actually knows something about this subject) was less than impressed. "The actuary is supposedly going to lower the assumed reinvestment rate from an absolutely hysterical, laughable 8 percent to a totally indefensible 7 or 7.5 percent,"

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he told the *New York Times*. "If I can give you one piece of financial advice: If somebody offers you a guaranteed 7 percent on your money for the rest of your life, you take it and just make sure the guy's name is not Madoff."

The good news is that it looks like states won't be able to get away with this fantasy accounting for much longer. The Governmental Accounting Standards Board (GASB)—a nongovernmental organization that has authority from the Securities and Exchange Commission to set rules for state and local government accounting—is on the verge of adopting new transparency rules for state pensions.

GASB will force inadequately funded pension systems to assume a far lower rate of return. State pension systems that are funded at satisfactory levels could continue using their own investment projections. This would have huge ramifications.

The proposed GASB rules don't go far enough for Wall Street, however. "I have been saying if there was going to be discipline imposed on the states, it would be through the market, not a regulator," Robert Novy-Marx, professor of finance at the University of Rochester, recently told Chicago business magazine *Crain's*. "I don't care how long they drag their feet—the market will drag them along."

In its most recent estimate of public pension debt, ratings agency Moody's applied a 5.5 percent annual return to all state pension funds and calculated state pension shortfalls to be $2.2 trillion. Under the agency's calculus, in Illinois, whose pension system is one of the nation's worst, the funding shortfall would jump from $83 billion to $135 billion.

Moody's also published a report last week noting that pension burdens are major contributors to the recent spate of city bankruptcies, which Moody's sees as part of an alarming trend of "distressed municipalities ... view[ing] debt service as a discretionary item in their budget." As such, unsustainable pensions are a major threat to the $3.7 trillion municipal bond market. Unfortunately, state pension problems are often the result of intractable state politics that won't easily be fixed. Once again, California is the exemplar: In 1998, Phil Angelides was elected state treasurer and began an aggressive campaign to use the fiscal might of California's pension funds to push all sorts of liberal ideas related to corporate governance and socially responsible investing.

"To this day, the California funds instigate a dizzying number of proxy fights at the companies in which they invest, focusing not just on governance-related issues like executive pay but on everything from carbon taxes to divestment from companies that do business with Sudan," observed Jon Entine of George Mason University in an article in *Reason* magazine. This politically motivated investment strategy has not worked out well. Entine noted one example among many: In 2003, "CalPERS rejected a recommendation from its financial adviser, Wilshire Associates, to invest in the equity markets of four Asian nations—Thailand, Malaysia, India, and Sri Lanka—based on their alleged misdeeds." That decision cost state retirees $400 million.

The recession does appear to have been something of a wake-up call, and states are slowly starting to address the pension problem. Between 2009 and 2011, 43 states cut benefits, increased employee contributions to pension funds, or did both.

Angelides left his job as state treasurer in 2007 and launched an unsuccessful bid to unseat Arnold Schwarzenegger as governor. That same year, the *Los Angeles Times* reported that CalSTRS had ousted investment banker David Crane—"a close friend" of Schwarzenegger—from its board for repeatedly questioning whether the pension fund was irresponsible to assume an 8 percent annual return. In 2009, President Obama appointed Angelides to head the Financial Crisis Inquiry Commission, which was tasked with writing a report detailing the causes of the 2008 financial crisis. Looking at the wreckage of California's pension plans—which were heavily invested in AIG, Citigroup, Lehman Brothers, and other major players in the meltdown—one might say that Angelides's chief qualification for investigating fiscal crises is instigating one.

The recession does appear to have been something of a wake-up call, and states are slowly starting to address the pension problem. Between 2009 and 2011, 43 states cut benefits, increased employee contributions to pension funds, or did both. In 2010 and 2011, 18 pension plans in 14 states lowered their return assumptions. Still, most pension reforms have been piecemeal and inadequate.

Further complicating states' pension woes is the related problem of retiree health costs. While the numbers aren't as big, the actuarial problem is even more acute—in 2010, state retiree health care liabilities were $660 billion, but "states had assets to pay $33.1 billion, leaving a $627 billion hole," according to Pew. Only 7 states have funded more than 25 percent of their retiree health care obligations.

Along with Wall Street, angry taxpayers might help get state pension funds under control, as they slowly realize they are on the hook for astronomical sums. There are already signs that this is happening: In addition to Scott Walker's recall election triumph and union reform success in Wisconsin, San Jose and San Diego residents have specifically voted to rein in public employee retirement packages this year.

But things are likely to get worse before they get better. Following the announcement of California's dismal returns last week, Fitch released a report saying that the ratings agency "expects numerous systems to report similarly disappointing returns." ♦