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Bad Accounting Can't Make the Public Pension Funding Shortfall Crisis Add Up: Manhattan Institute

Introduction

Public-sector pensions are underfunded, and the problem is getting only worse. Despite many years of high asset returns, municipal and state finances face a slow-moving crisis as the bill comes due on their pension obligations. The burden will either fall on taxpayers or lead to cuts in benefits on retirees and essential services on the entire tax base. The time to fix an underfunded pension plan is always yesterday, but the current high-interest-rate environment offers an opportunity to put public-sector pensions on a more sustainable path. This will require changes at the state, local, and federal levels.

The core of the problem is pension accounting. The extent of underfunding is obfuscated by the current accounting standards that enable states and municipalities to underprice risk and the cost of their obligations. State and local pension plans use accounting standards suggested by the Governmental Accounting Standards Board (GASB), a nonprofit body, in order to measure their funding status in their Annual Comprehensive Financial Report (ACFR). These guidelines often influence the contributions that fund the plans.

GASB's accounting standards are at odds with basic finance and are different from how pension liabilities are measured in the private sector. The current standards not only obscure the extent of underfunding; they create an incentive to invest in riskier assets and provide overly optimistic return assumptions. Research shows that overly optimistic return assumptions are a big driver of the increase in underfunded liabilities.[1]

For decades, critics have called for public pensions to adopt more defendable and commonly used accounting standards.[2] This would involve using market-based discount rates (the rate of return used to calculate future cash flow), particularly low-risk government interest rates. Lower and more defendable rates would reveal the extent of the underfunding based on current market rates, which is correct. But if states and cities realize the truth, it could result in dire financial consequences for some municipalities because it could mean higher contributions or higher municipal interest rates.

True, the underfunding reported in an ACFR does not necessarily have any direct impact on the contributions that states and cities pay to fund their pensions. But it enables further underfunding because it suggests that risk is costless and that providing pension benefits is cheaper than it is. The underfunding is also important because the funding level is observed by municipal bond buyers, highly motivated voters, and anyone with an interest in the health of the pension, such as unions. There is evidence that pensions do respond to what is in ACFRs. For instance, states and cities raised contributions when discount rates were lowered after the guidance was changed in 2012 because the local governments feared pressure from their stakeholders.[3]

While informing these stakeholders on the true extent of pension funding is desirable from an economical and long-term fiscal sustainability perspective, a drastic change could be self-defeating.

States and municipalities are required to use GASB accounting in their ACFRs, but they are not required to make the necessary contributions estimated by GASB to cover the underfunding or even to use the same method to estimate their contributions. If the standards are seen as completely unreasonable or unrealistic, they will have less influence, which could worsen transparency and lead to more irresponsible investing.

Although the 2012 move faced resistance, it was, at best, a half-measure that sent mixed messages. Thus, even a few years ago, when rates were near-zero, moving to a more defendable standard would have been politically untenable. Our higher-interest environment changes this situation because the difference in expected return and interest rates is no longer so large. (In fact, in the last higher-rate environment, the 1990s, many pensions were overfunded.)

The current high-rate environment is an opportunity for states and municipalities to get on the right track by adopting better and more uniform standards for how liabilities are measured and for how contributions are calculated and paid. Ideally, this reform would encourage states and municipalities to start managing interest-rate risk, so that if rates fall or rise in the future, pensions would still be properly funded.

It is expensive to guarantee funding for pensions, but it can be managed using simple interest-rate hedging strategies. When the expected return is the discount rate, there is no incentive to use these strategies because the plan sponsor is fixated on returns rather than risk management. Requiring the sponsor to account for risk and the cost of a guarantee, which this issue brief explores, changes the focus for states and cities and makes the benefits of risk management more apparent.

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