PENSION FINANCE AND CONNECTICUT'S SPENDING CAP

Anthony Randazzo
Pension Integrity Project
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Reason

Pension Contributions & the Spending Cap

- Should all state contributions towards retirement benefits be considered "general budget expenditures"?
- My view: Yes
  - If public employee salaries are considered general budget expenditures, then *employer contributions towards promised pension benefits should also be considered general budget expenditures.*
  - Defined benefit pensions are a form of compensation; specifically, deferred compensation in lieu of salary today.

But an understandable question: what about unfunded liabilities?

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How Defined Benefit Plans Are Funded
Different Funding Approaches

- Defined Benefit Retirement Plan = “Pre-funded”
- Social Security = “Pay-as-you-go”

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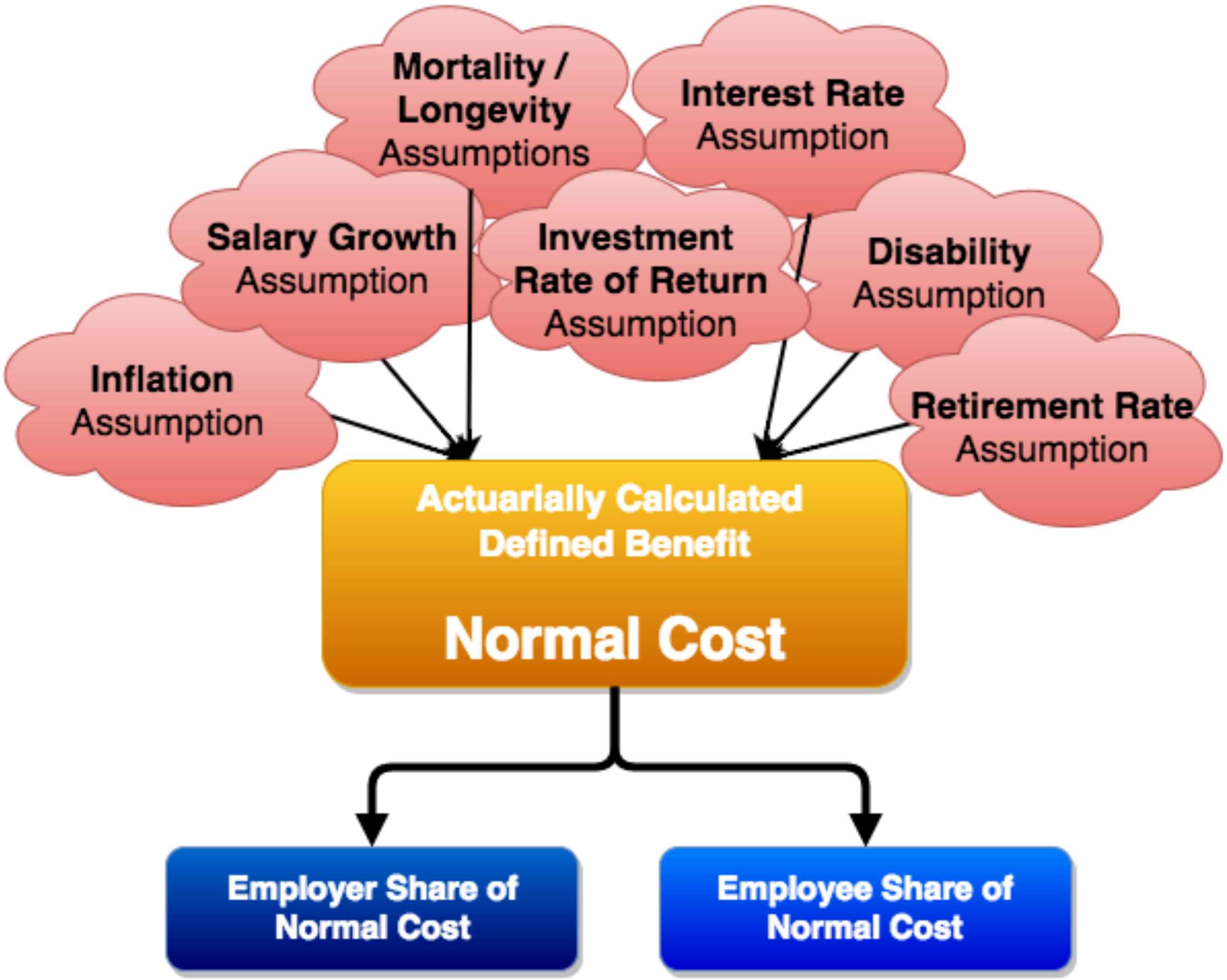
How Defined Benefit Plans Are Funded

Calculating the "Normal Cost"



How Defined Benefit Plans Are Funded
Calculating the Employer Contribution

The Source of Unfunded Liabilities

- Inaccurate actuarial assumptions + Unaccounted for benefit enhancements + Employers underfunding necessary contributions = Unfunded pension liabilities

Actuarially Determined Employer Contribution

- Employer share of actuarially calculated normal cost + Unfunded liability amortization payments = Employer contribution

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Unfunded Liabilities as a Accounting Tool

"Pension Debt" ≠ General Obligation Bonds

- Unfunded liabilities are sometimes called "pension debt"; this plain English term for actuarial jargon risks mischaracterizing the nature of unfunded liabilities.

- Unfunded liabilities *are not* debt in the same way that general obligation bonds or tax revenue bonds are debt.

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Unfunded Liabilities as a Accounting Tool

"Pension Debt" ≠ General Obligation Bonds

- "Accrued Liabilities" is a technical term to define the amount of promised pension checks to public sector employees.

- *Whether this liability is "funded" or "unfunded" depends on the accounting methods used to estimate the value of those liabilities.*

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Unfunded Liabilities as a Accounting Tool

Calculating Unfunded Liabilities

Unfunded Accrued Liabilities

- Value of Promised Pension Benefits (Accrued Liabilities) – Value of Assets Available = Unfunded Liability

Connecticut SERS Example:

- $26.3 billion in promised benefits - $11.4 billion in assets (actuarial value) = $14.9 billion unfunded pension liability

So how is the value of promised pension benefits, the accrued liability, calculated?

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Unfunded Liabilities as a Accounting Tool

Determining the Value of Accrued Liabilities

Connecticut TRS
Unfunded Liability Sensitivity Analysis (FYE 2014)

Discount Rate	Accrued Liabilities (i.e. Promised Pension Checks)	Assets (Market Value)	Recognized Amount of Unfunded Pension Liabilities
9.5%	$23.97 billion	$16.21 billion	$7.76 billion
8.5%	**$26.35 billion**	**$16.21 billion**	**$10.14 billion**
7.5%	$29.15 billion	$16.21 billion	$12.94 billion

Source: Connecticut TRS GASB 68 Report, FYE 2014
Note: The bolded row notes the actual discount rate that was used by TRS for the fiscal year ending 2014.

The amount of unfunded liability depends on how the accrued liability is calculated… which depends on the discount rate used… which is an accounting policy choice.

Conclusion

- The amount of unfunded liability that a pension plan reports is simply a function of the assumptions and accounting practices the plan chooses to adopt.
- By contrast, traditional government debt—such as general obligation bonds or revenue bonds—involves *bonded debt with fixed interest rates and fixed repayment schedules.*
- Therefore: unfunded liability amortization payments should not be considered “evidences of indebtedness” or excluded from the constitutional spending cap’s definition of general budget expenditure.