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**Reason Foundation**

**Before the Spending Cap Commission**

**State of Connecticut**

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Members of the Commission, thank you for the invitation and opportunity to speak with you today about pension financing, as it pertains to Connecticut's constitutional spending cap.

My name is Anthony Randazzo. I am an economist and a managing director of Reason Foundation's Pension Integrity Project. Reason Foundation is a nonprofit, 501(c)3 research foundation that is dedicated to using market-based public policy research to effect good governance best practices across the 50 states. Our Pension Integrity Project is focused on providing technical support to pension plan stakeholders who are seeking to improve the solvency of their public sector retirement systems. We've worked with elected officials and public sector union groups in over a dozen states.

The technical details and mechanics of public sector pensions can be very complicated, making them often misunderstood. Today I hope to clarify how public sector retirement plans — in particular defined benefit pension plans — are structured and why the particularities of how they get financed are so important for your decisions as a commission.

It is my understanding that part of this Commission's charge is to determine whether *all* state contributions towards retirement benefits should be considered "general budget expenditures." Insofar as public employee salaries or compensation are considered general budget expenditures, *it is my opinion that, yes, all state employer contributions towards promised pension benefits should be deemed general budget expenditures*. This is because a defined benefit pension is a *form of compensation* — effectively deferred compensation in lieu of certain salary today.

I want to emphasize here that I mean *all* employer contributions towards pension benefits, including both the annual so-called *normal cost* for benefits, as well as any *unfunded liability amortization payments*. I recognize that this is a matter of some contention, so I would like to focus my comments today mostly on why unfunded pension liabilities should not be considered "evidences of indebtedness" and thus, exempt from the general budget expenditure label.[1]

Before discussing this position, it will be helpful to briefly review how defined benefit retirement benefits are paid for.

## How Defined Benefit Plans Are Funded

Defined benefit pension plans such as Connecticut's State Employee Retirement System (SERS) or Teachers Retirement System (TRS) are structurally designed to be "pre-funded." That is, during the years an employee is earning benefits, the plan should receive enough contributions to pay out all of the retirement benefits promised to that employee.

Structurally, this is different from Social Security, where current workers are taxed to pay the benefits of current retirees, also known as *pay-as-you-go* financing. One way to think about this is that when an employee in SERS or TRS retires, the plan should effectively have on hand the total dollars needed to purchase a lifetime annuity on that employee's behalf.

In order to calculate how much should be saved in any given year so that a pension plan has enough on hand to pay all promised retirement benefits, actuaries use a range of assumptions about how long employees will work, how long current employees will continue in their jobs and how much they will earn over the rest of their careers, how long retirees will live — even what the marriage/divorce patterns of public workers will be (because some pension benefits can go to spousal or child beneficiaries)—and much more. Actuaries also ask a pension board what it assumes the pension plan's investment return will be over a long-term period, and uses that in their estimate.

Based on the range of assumptions, actuaries calculate how much should be contributed to the pension plan in a given year, which is known as "normal cost." If the normal cost calculation is right, then a pension plan will always have the assets on hand to pay every promised retirement benefit check.

## Understanding "Unfunded Liabilities" as an Accounting Tool

Unfortunately, pension funds across the country — including Connecticut's defined benefit pension plans — have mostly underestimated what normal cost should have been over the past 10 to 20 years. Many actuarial assumptions have turned out to be either inaccurate or unrealistic, such as overestimating what the rate of return on pension assets would be. Legislatures have increased benefits without consideration as to whether assets would be available to pay for them. And to make matters worse, in some places — again, including Connecticut — policymakers have just chosen to pay less than 100% of actuarially recommended rates.[2]

When actuarial assumptions about the future don't match reality or when employers don't make all of their recommended contributions the result is what actuaries refer to as "unfunded actuarially accrued liabilities" or "unfunded liabilities" for short.

Unfunded liabilities for a retirement system are commonly referred to as "pension debt." And this terminology is helpful for conveying a plain English understanding of a very jargon-filled actuarial accounting term. However, it does run the risk of mischaracterizing exactly what unfunded liabilities are.

Instead of being "debt" in the sense that a general obligation bond or revenue bond is debt, *the term "unfunded liability" is an accounting concept*. Unfunded actuarially accrued liabilities are not technically debt that is owed to a person or institution.[3]

In actuarial jargon the "accrued liabilities" that are either funded or unfunded are the total amount of promised pension benefits. Every day that a public sector employee works, he or she earns an increased retirement benefit. Their retirement checks will be based on a combination of factors, including how much they earn during their employment, how long they work for the state, and what kind of job they do. At any given time, actuaries can estimate what an individual's retirement benefit will be, i.e. what the dollar amount of their monthly pension check will be. This amount that the state has promised to pay the worker is the "accrued liability" that the state is taking on.

*Whether this accrued liability is "funded" or "unfunded" depends on the accounting methods used to estimate the value of those liabilities, and amount of assets available to pay those liabilities.*

## How Unfunded Liabilities Are Calculated

In one sense, the unfunded liability is easy to calculate. You simply count up all promised pension benefit checks (again known as the liabilities of the plan), report the value of those promised checks in today's dollars, and see if you have enough assets on hand to pay out all of those benefits.

For Connecticut SERS, the reported plan assets at the end of 2015's fiscal year were $11.4 billion (using the actuarial value of assets) and the reported liabilities (promised pension checks) were $26.3 billion. Thus, the unfunded liabilities were $14.9 billion.

However, where things get complicated is in the process of reporting the future value of all promised pension checks in today's dollars.[4] Actuaries use what is called a "discount rate" to take the estimated amount of promised pensions and report how much that is in current dollars. The discount rate transforms the total amount of pension checks paid out over time into a single dollar amount today. And that single dollar amount is what gets reported in actuarial valuations and annual reports as the "accrued liability" of a pension plan.

Now, it just so happens that there is no universally agreed upon method of picking a discount rate. How to select an appropriate discount rate is such a debated topic that it recently caused a long standing joint committee between the Society of Actuaries and the American Academy of Actuaries to break up. And while I would be happy to elaborate on the specifics of this debate, the important takeaway is that there is no universal rule that Connecticut can appeal to when picking a discount rate.

This is important because the higher the discount rate used, the lower the reported value of accrued liabilities. Conversely the lower the discount rate used, the higher the reported value of accrued liabilities. For example, consider the following:

**Connecticut Teacher Retirement System**

Unfunded Liability Sensitivity Analysis Given Varying Discount Rates, for Fiscal Year Ending June 2014

| Discount Rate | Value of Accrued Liabilities (i.e. Promised Pension Checks) | Market Value of Assets | 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 2014 GASB 68 Actuarial Report

Note: The bolded row notes the actual discount rate that was used by TRS for the fiscal year ending 2014, and the reported unfunded liability. The figures at 9.5% and 7.5% represent the value of accrued liabilities (and unfunded liabilities) given a discount rate 100 basis points above and below the plan's adopted discount rate.

Which of these is the correct measure of accrued liabilities or unfunded liabilities? The discount rate to use is an actuarial accounting policy choice by the TRS board in this case, and that will change the recognized amount of unfunded liabilities — but it is important to reiterate that the discount rate and actuarial assumptions are completely irrelevant to the *actual amount of pension liabilities* for Connecticut's retirement systems. As long as the state guarantees it will pay promised pension benefits, the total dollar amount of pension benefits paid to state employee retirees will be whatever it needs to be based on how long they work, what they are paid during their careers, and how long they live in retirement. The reported unfunded liability is just a recognized method for estimating what those benefits will be and whether there is enough saved to pay for them.

The discount rate and other actuarial assumptions are just methods by which we can estimate the amount of accrued liabilities. In that sense, the discount rate and reported liability values are simply accounting tools.

## Why All Required Pension Contributions Should Be Considered "General Expenditures" and Not "Indebtedness"

Thus, 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. As long as Connecticut is going to pay all of its promised pensions, then how much it chooses to contribute towards those pension plans today in the form of normal cost versus in the future in the form of unfunded liability amortization payments is simply an accounting policy choice.

For example, SERS and TRS could choose to adopt a 15% assumed rate of return and discount rate tomorrow and virtually wipe out the unfunded liability — on an accounting basis. This wouldn't change how much the state ultimately needs to have to pay out to beneficiaries via monthly pension checks though.[5] And the state would just be forced to pay for those benefits via unfunded liability amortization payments in the future instead of normal cost payments today.

By contrast, traditional government debt—such as general obligation bonds or revenue bonds—involves *bonded debt with fixed interest rates and fixed repayment schedules.* This is debt that is underwritten by financial institutions and sold to investors. These tax-exempt municipal bonds, revenue bonds, or forms of taxable government debt are securities that can be purchased by private sector investors and an array of different types of institutional investors (including public pension funds themselves).

Meanwhile, pension obligations are effectively promised, deferred compensation to public employees; unfunded pension obligations (aka unfunded liabilities) do not resemble marketable securities in the least. The amount of *recognized* unfunded liabilities by a pension plan is malleable based on assumptions.

Support for this perspective can be found by looking at how municipal bankruptcy courts across the country have treated pension obligations and municipal creditors very differently. Pension obligations are almost always considered the most senior claims to taxpayer resources, in large part because states oftentimes either explicitly guarantee pension payments in their constitutions, or define pension promises as a compensation contract—either of which is inherently different from a debt obligation.

## Conclusion

Therefore, because unfunded liabilities are simply an accounting metric, and not a fixed debt instrument, they should not be counted among Connecticut's evidences of indebtedness. And, if employee compensation is to be considered a general expenditure of the state, then all payments necessary to provide retirement benefits — which are simply a form of deferred compensation — should also be considered a general expenditure.

Thank you and I look forward to answering any questions you might have.

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[1] The specific language I understand to be guiding the Commission is: "General budget expenditures shall not include expenditures for payment of the principal of and interest on bonds, notes or other evidences of indebtedness."

[2] This is not intended to be a comprehensive list of the ways that unfunded liabilities could emerge within a plan, but rather a list of some typical ways unfunded liabilities accumulated in U.S. defined benefit plans over the past few decades.

[3] If anything, the amount owed to pension beneficiaries is the "liability" to be considered a kind of debt, though accrued liabilities are still dissimilar to bonded debt.

[4] Again, recall that actuaries estimate a number of factors about demographics, salary growth, and mortality rates in order to count up the total estimated number of pension checks that will be paid out by a state pension plan.

[5] Generally speaking, a pension plan develops unfunded liabilities when the contributions made to the system are not enough to pay out the promised pension benefits. Contributions might be too low for a number of reasons. In the case of Connecticut, it is a combination of the state not paying the actuarially recommended amount every year, as well as inaccurate actuarial assumptions, such as what the investment return the state could earn over the long-term. In fact, even if the state had paid 100% of what actuaries recommended every year in the past, the plan would still have unfunded liabilities today because the actuarial assumptions that were being used haven't matched actual experience of the plan. Whatever the source, the unfunded liabilities of SERS, TRS, and JRS are simply an accounting reflection of what the state estimates it is going to pay in pension benefits and how much is on hand to pay those benefits. If the state wanted to make the unfunded liabilities "go away" on an accounting basis, SERS could simply use a discount rate high enough to reduce the recognized amount of accrued liabilities to equal whatever assets the state plans have on hand. This would not change the *actual* liabilities though. The state would still have to pay out all promised pension checks from some revenue source.