Forbes

Andrew Biggs Contributor

I work on retirement policy, public sector pay and other issues.

OPINION 6/01/2016 @ 2:42PM | 523 views

U.S. State And Local Pensions Couldn't Survive Under Tougher International Accounting Standards

State and local government pensions admit to being underfunded by over $1 trillion. But using the tougher accounting standards applied in other countries, state and local pension deficits would rise five-fold. The sad reality is that many state and local government plans couldn't survive without bad bookkeeping.

The Governmental Accounting Standards Board – known as "GASB" – recently held a joint conference with the International Public Sector Accounting Standards Board (IPSASB). Both organizations are responsible for setting accounting standards for government employee pension plans. But if GASB and the U.S. state and local pensions industry looked at IPSASB's pension accounting standards, they might be shocked: those standards precisely contradict the loose pension accounting rules that GASB promulgates and that the public pensions industry depends on. It's no exaggeration to say that U.S. state and local pension may not be financially viable if they were required to live under the IPSASB accounting rules that other countries follow.

As I wrote recently, public employee retirement plans in most other countries use more conservative accounting rules and fund more responsibly than state and local government pensions here in the U.S. Our state and local pensions are about the worst-funded of any plans studied by the OECD. That's one reason why we talk of a public sector "pensions crisis" here in the United States.

Both GASB and IPSASB are responsible for rules that determine how governments value the liabilities for their public employee pensions. GASB's rules apply to state and local governments here in the U.S. while the IPSASB sets rules for pension plans in countries like Australia, Canada, the U.K. and – to varying degrees of adherence – several dozen other countries around the world.

The big issue here is how to value public employee pension liabilities – that is, how to put a number to the amount of money the retirement systems owe. This liability figure heavily influences how much governments choose to set aside to fund their pensions. And the size of pension contributions can have a big effect on state and local government budgets.

In the U.S., GASB allows pension plans to "discount" their pension liabilities using the rate of return the plans assume they will earn on their investments, which is usually around 7.7%. That rate of return is based on a portfolio typically consisting of about three-quarters risky assets such as stocks, real estate, private equity and hedge funds. The upshot of this accounting system is that – contrary to what economic logic says – the more investment risk a U.S. pension plan takes, the smaller the plan's (reported) liabilities and the smaller the pension contributions the sponsoring government makes. Literally, it's take more risk = better funded = contribute less. Not surprisingly, academic research has found that these accounting incentives explain why U.S. public sector pensions take more investment risk than either corporate pensions or public employee retirement systems in other countries. State and local pensions are "teaching to the test" — they're investing based on how the accounting rules reward them rather than by what financial logic would dictate.

The IPSASB standards work differently. IPSAS Standard 25 states, "The discount rate reflects the time value of money but *not* the actuarial or investment risk." In English, this implies a discount rate based on low-risk investments, such as government bonds, where the interest paid is a reward for waiting to get your money back, not – as with risky investments like stocks – a reward for the chance that you won't get your money back at all. IPSAS 25 also states that the discount rate should be matched to the duration of a pension plan's liabilities, another thing that state and local plans don't think much about. So if the average accrued pension benefit will be paid 15 years from now – which is usually about right — then the average yields on 10 and 20-year government bonds would be a good approximation. As of today, that would call for a pension discount rate of about 2%.

Here's the logic: if a pension plan is promising a truly guaranteed benefit to be paid (on average) 15 years from now, the cost of providing that benefit – otherwise known as "the liability" – is the cost of funding it with guaranteed investments like U.S. Treasuries. Funding with risky assets, as state and local pensions generally do, will *usually* produce lower costs than funding with Treasuries, but not always. And the "liable" part of liability is the legal obligation for the taxpayer to pay full benefits even when a pension's investments fall short of expectations. Pretty much every state and local government is currently familiar with that obligation, with pension costs that have roughly tripled since the market downturn beginning in 2007. And that's why GASB accounting, while it might provide a best-guess as to the expected cost of a pension plan, doesn't measure a pension plan's *liabilities*.

Adhering to the IPSASB accounting standards that other countries' public employee retirement plans follow would be like a hurricane hitting U.S. state and local pensions. Roughly speaking, a pension's liabilities increase by about 15% for each 1 percentage point reduction in the discount rate used to value those liabilities. So shifting from a 7.7% discount rate to a roughly 2.0% rate would more than double reported pension liabilities while unfunded liabilities would rise five-fold to about $6.75 trillion. With liabilities accurately valued, most state and local pension plans aren't financially viable. Most governments aren't even making their full contributions under GASB's funny-money accounting rules. Very few could make full payments under stricter standards needed to truly fully fund the plans. The hard truth is that to survive, many state and local pensions depend upon faulty accounting. That's a bad place for them and the country to be.

But don't worry, America – opinion is still divided on how to value pension liabilities. On one side we have GASB and the state and local pensions industry, backed by the actuarial and investment firms that cater to them. But on the other side we have IPSASB accounting standards and the pension funding practices of many other developed countries; we have corporate pension accounting standards right here in the U.S.; we have 98% of professional economists; and we have the way in which financial markets value liabilities of different sorts every day. Opinion on valuing public employee pension liabilities may be divided, but it's sure not divided equally.

If you think the U.S. public pensions industry knows better than all these other groups, rest easy. Under GASB standards, state and local pensions are only underfunded by a trillion dollars or so. But if maybe, *just maybe*, the rest of the financial world has it right and the public pensions industry is wrong, then pension underfunding is a much bigger problem than we'd previously thought.