"Improving Public Pension Transparency"
May 5, 2011
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

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Chairman Boustany, Ranking Member Lewis, and members of the Subcommittee, good morning. Thank you for inviting me to testify today on this important topic.

Over the last 18 months, alarm bells have started going off in state capitols and city halls around the country about the unsustainable costs of public employee pensions. State and local officials understand the huge crush that rising pension costs are imposing on their budgets: as one example, the city of San Francisco expects its annual pension contribution to rise from $357 million in the current year to $800 million in two years.

State lawmakers are responding by passing pension reform laws. In 2010 alone, 18 states passed some sort of law to reform its public employee pension system. But as lawmakers make important decisions about the future of employee retirement benefits, they are hampered by the lack of transparency in pension funds' financial reporting.

Reviewing a public pension fund's Comprehensive Annual Financial Report does not necessarily make it possible to answer basic questions, such as: how much do we owe? How much do the pension benefits we provide cost? And how can we expect pension contributions to change over the next several years? Without the answers to these questions, lawmakers do not know what kind of pension reform their jurisdictions need—and relatedly, many recent pension reforms have been underwhelming.

Overly expensive and insufficiently funded pension plans are a state and local problem. But Congress can play a valuable role by requiring greater financial transparency by state and local pension funds. The federal government has particular reason to act because of the specter that states with unacknowledged and unresolved pension troubles may someday look to Washington for bailouts.

There are a few key areas in which the federal government should encourage better reporting. Some of these transparency ideas are included in HR 567.

- **Discount rate.** Retirement plans use a "discount rate" to convert pension or OPEB liabilities due far in the future into a present value. Government Accounting Standards Board (GASB) guidance leads plans to use discount rates that are unreasonably high. Such rates allow them to understate their true liabilities and claim to be better funded than they really are. Plans should additionally report their liabilities discounted at a lower rate that corresponds to the low risk borne by pensioners that they won't be paid. Doing this would result in plans' reporting a higher (and more accurate) present-value liability and a lower ratio of assets to liabilities (the "funding ratio").

- **Smoothing**. Most retirement plans do not recognize unusual gains or losses on assets immediately. Instead, they recognize them over a period of years—most often, five. Unfortunately, some plans have been changing their smoothing periods opportunistically: shortening them to recognize sharp gains quickly, or lengthening them to delay recognition of losses. Doing this allows funds to overstate the value of the assets they hold and thus make their unfunded liabilities seem smaller than they actually are. Jurisdictions in which plans have taken such steps include New Jersey in the wake of the dot-com stock bubble; and more recently Arizona, Los Angeles, South Carolina and West Virginia. Plans should instead use a standardized smoothing period of no more and no less than five years at all times. They should also continue to separately report the market value of their assets as of particular dates and disclose the funding ratio on both a smoothed and an un-smoothed basis.
- **Projections**. When a pension plan's financial position deteriorates, actuaries direct the plan's sponsors (i.e., state and local governments) to contribute more money. But because of asset smoothing, it takes several years before a protracted decline in stock prices is fully recognized, forcing sponsors to deal with the shortfall by increasing their contribution rates. Pension fund managers know that stock-market losses, especially the steep ones of recent memory, are very likely to drive required employer contributions higher in the coming years, as past losses are gradually recognized. However, because most plans do not issue public projections of contribution rates, legislators do not necessarily have fair warning of these impending increases. Therefore, pension plans should annually issue five-year projections of employer contribution rates, so that lawmakers can plan to accommodate rising pension costs in future budgets—or enact pension reforms to lower costs.
- **Normal Cost.** The factors that obscure the aggregate cost of pension plans also obscure the cost per employee. Employer contributions are the basis for current measures (such as those published by the U.S. Bureau of Labor Statistics) of these costs, but they do not represent the full cost, which is the present value of the pension credit that employees receive for providing service in the current year. Public pension plans should report the market value of this ongoing cost, as private firms already do. This figure is the true "cost" of offering pension benefits, whether it is met with cash in the current year or by incurring a liability that will be covered in the future. The unavailability of accurate measures of the present value of pension and retiree health care benefits paid to public workers has been a key problem in answering questions about whether or not public employees are overpaid compared to similarly-situated private sector workers.

If pension plans adopt disclosure practices as outlined above, state and local lawmakers will be easily able to answer the questions I laid out earlier in my testimony. This will empower them to take steps to lower the cost of public employee pension benefits (if appropriate) and prepare to make room in upcoming years' budgets for rising costs (if necessary). It will also provide better information to bondholders seeking to evaluate states' creditworthiness.

It is up to state and local governments to decide how to structure employee retirement benefits and how generous they should be. Greater transparency will not require states and localities to make any substantive changes to retirement benefits. However, governments should not make pension policy in the dark. It is likely that greater transparency will lead states to enact more aggressive pension reforms by showing how burdensome pension costs are and will become in the next several years.

Thank you again. I am happy to take questions and comments.

Further reading:
Josh Barro, "Unmasking Hidden Costs: Best Practices for Pension Transparency." Manhattan Institute, February 2011.
Josh Barro, "Good Pension Policy Requires Transparency." *The Hill*, February 10, 2011.
Josh Barro, "Dodging the Pension Disaster." *National Affairs,* Spring 2011.