

Professor Robert Novy-Marx Testimony

State and local pension systems are significantly underfunded. The shortfalls faced by these systems represent massive debts that public employees and retirees expect state and local taxpayers to repay. The amounts that are owed are large enough to threaten the continuing viability of many state and local government systems, and pose considerable risks for federal taxpayers.

The exact magnitude of the problem has been concealed by the flawed accounting methodology prescribed by the Government Accounting Standards Board (GASB). I can illustrate these flaws with a simple example. If I take a dollar out of my right pocket, and put it into my left pocket, I presume that you all will agree that doing so has made me neither richer nor poorer. The idea that moving money from one pocket to another could somehow make you richer insults common sense.

Yet this idea is the basis of the states' current claims that their pension funds are "only" \$1 trillion underfunded. Under GASB rules a plan's reported financial status improves when it takes on more investment risk. When a plan moves a dollar from its right pocket (bonds) to its left pocket (stocks), it magically gets "richer" (less underfunded).

This logic is clearly flawed. A dollar of stock is not worth more than a dollar of bonds. When you as an individual move money from a money market fund into the stock market you are not suddenly richer. You do not get to pretend that you owe less on your home mortgage. The payments you are obligated to make on your house are completely unchanged. How you invest your assets has no impact on the current value of your liabilities. This is just as true for the states as it is for individuals, despite GASB's claims to the contrary.

Properly accounted for, the unfunded portion of pension promises already made to state and local workers is roughly \$3 trillion, or three times as large as that recognized under GASB. This exceeds all recognized state and local debt combined, and represents a debt owed to state and local government workers of roughly \$25,000 for each US household.

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These large unfunded liabilities are a serious concern. Perhaps even more troubling, however, is how the current methodology accounts for new benefit accruals— that is, how governments value retirement benefits as a part of workers total annual compensation. Under current accounting the annual recognized cost of newly earned pension benefits averages roughly 12-15% of total wages, with plan members contributing, on average, slightly less than half that amount. The true cost of new service accruals is roughly twice as large, 25-30% of total wages, meaning that each year most state and local workers earn employer financed pension benefits worth more than 20% of their salaries.

This is not to say that public employees are overcompensated. I personally value the services provided by government workers, and am certain that many public sector workers are underpaid. This does not, however, provide an excuse for misvaluing the benefits they receive. Undervaluing the deferred compensation these pension benefits represent has serious negative consequences for the way governments operate. It encourages excessive growth in public sector costs. It also encourages states to finance current operations with off balance sheet debt, leaving even larger bills for future taxpayers.

In negotiations between states and their workers, undervalued retirement benefits give both sides at the bargaining table an incentive to trade current wages for future pension benefits. Workers will happily give up a dollar today for two dollars worth of benefits that the government accounting methodology values at less than a dollar. Current administrations may happily agree to this arrangement if it frees up money in current budgets. As a result, state, city, and county pension plans have become a pervasive tool for circumventing balanced budget requirements.

Because current contributions fall short of the cost of new benefit accruals, the state and local pension problem is getting worse, not better, and this represents a concern for the Federal Government.

If the Federal Government cannot credibly commit to allowing states to fail, then the states have little incentive to fix their problems. In the event of a Federal bailout taxpayers in fiscally more responsible states will subsidize those in more profligate states. So any state that undertakes the unpalatable combination of tax increases and service cuts required to address its pension problems now risks losing its share of any Federal funds used in the future to rescue the system.

The Federal Government consequently has an urgent need to establish incentives for states to deal with their pension problems. The Public Employee Pension Transparency Act (H.R. 567) is a useful first step. Congress should consider even stronger measures, however, to ensure that federal taxpayers are not the ultimate underwriters of state debts. These should include incentives for states to close current plans to new workers, and to instead enroll new hires in transparent defined contribution plans and Social Security. They should also encourage states to recognize the true magnitude of their legacy pension liabilities.