ACCOUNTING, POLITICS AND PUBLIC PENSIONS IN THE US

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Abstract

This paper reviews the political rationale of public pensions and implicates the accounting profession in facilitating the accumulation of public pension debt through complex technical jargon and flexible reporting practices. Using theories of political economy, we explain how defined benefit pension plans offer politicians a convenient way to satisfy public employee demands while providing the means to defer budgeted cash payments and obscure the accumulation of public debt from taxpayers. Research supports our contention that complexity in public pension disclosures may overwhelm the average taxpayers' ability to understand and respond to the financial risks being taken by their elected officials in a timely manner. Democratic principles support the right of taxpayers to understand the nature and implications of the risks being taken on their behalf to financial stability and intergenerational equity. The profession is admonished for its claims to act in the public interest when the disclosures it promulgates fail the tests of understandability and usefulness to the citizenry.

Keywords: Public Pensions, Accounting, Political Economy, Public Interest

"Rather than responding to the needs of the original three primary users of governmental financial statements - "the citizenry, legislative and oversight bodies, and investors and creditors" - the GASB has moved almost entirely toward the interests of its more powerful and financially influential constituents, namely state and local governments, and the parallel interests of their politically influential employees." Comment Letter 208, GASB 27 Exposure Draft, By Diann Shipione, former trustee of the San Diego, California City Employees' Retirement System pension board. Dated Oct. 14, 2011.

1. Introduction

In this paper we highlight how politics and accounting have combined to create an environment where public pension debt can accumulate with little or no taxpayer oversight. The focus of this paper is on the accumulation state and local (S&L) public pension debt in the U.S. We use the term "public pensions" to mean those defined benefit (DB) retirement plans managed by S&L entities such as counties, cities, municipalities, school districts, state universities and similar governmental or quasi- governmental entities. DB plans pay a retirement income for the life of an employee and are supposed to be funded through an actuarially determined contribution dependent upon various assumptions, such as life expectancy, future rates of return and benefit payouts. Unfortunately, DB plans have become less sustainable over the last several decades as increasing numbers of retirees live longer while yields on investments have declined. In response to these factors and others including increased regulation over minimum funding requirements and a more mobile workforce, private sector companies have all but abandoned DBs in favor of more portable, employee funded defined contribution plans. Public employees have been more successful than their industry counterparts in retaining access to traditional DB plans, but many state and local governments now offer DC plans alongside their DB options and those in financial distress are restricting new entrants to existing plans and slashing benefits. This trend towards DC plans has the effect of shifting primary responsibility for retirement saving and investment risk to employees while reducing employer contributions, and ultimately, employee benefit payouts upon retirement. It is also important to note that public pension plans are not insured through the Pension Benefit Guarantee Corporation that covers commercial pensions subject to the Employment Retirement Income Security Act (ERISA) of 1974. Furthermore, many participants in S&L public pensions either cannot, or have elected not to, participate in Federal Social Security making public pensions their sole source of retirement income. It has been estimated that about 27% of all state and local government workers are not covered by Federal Social Security, including about 40% of public school teachers (Gale, Holmes and John, 2015). These employees are in a particularly vulnerable position if S&L governments are unable to fulfill their pension obligations.

Public pension debt is cited as a major contributing factor in the bankruptcy of some local governments, such as Detroit, MI, San Bernardino, CA, Stockton, CA, Jefferson County AL, Harrisburg, PA and others (Weingarden, 2014). S&L

governments can file for bankruptcy under Chapter 9 of the Federal Bankruptcy Code (11 USC, 109) and cram down benefit cuts or claw backs on their employees. This occurred in 2013 in Detroit, Michigan, where 12,000 retirees, each receiving an average of $19,000 a year had to pay back $212 million in 'excess interest' previously distributed, followed by a 6.7 percent cut to their paychecks (Christoff, 2015). This was done despite a state constitutional guarantee protecting their public pension. These pension cuts were subsequently upheld by a Federal appeals court (Chambers, 2016). Current estimates of the total unfunded pension liability range between $3-5 trillion depending on the methods and assumptions used in their calculation (Norcross and Gonzalez, 2016, Biggs, 2016; Novy-Marx and Rauh 2011, Munnell, Kelly, Sass & Aubry, 2008). The swelling unfunded obligation for state and local pensions due to the retirement of the baby boomer generation has been characterized as a pension tsunami that places an unfair burden on future generations of workers. While the exact size of the unfunded debt may be debated, experts agree that state and local pensions are in a crisis (Norcross and Gonzalez, 2016) and taxpayers are demanding answers to how this financial crisis occurred (Gantert 2016).

We argue the growth in unfunded public pension debt is occurring primarily because defined benefit pensions offer a satisfying solution to labor demands while providing politicians a flexible payment schedule with limited debt transparency to taxpayers. Using theories of political economy (Thornburg and Roberts, 2008; Ansolabehere, Snyder and Tripathi, 2002; Leyden, 1995) we explain why politicians should prefer defined benefit public pensions as a negotiating tool and critically evaluate the accounting professions' role in protecting taxpayer interests. Since the technical complexity of pension accounting is beyond the average taxpayers' ability to understand, the profession has an obligation to evaluate and report the financial consequences of government labor negotiations to the public in a fair and understandable manner. We believe the profession has failed to discharge this responsibility, and as a result, voting taxpayers have been largely unaware and complacent about the accumulating debt.

We present our argument in three parts. Section 2 analyzes the political economy of public pensions including how and why they are used to facilitate labor negotiations between public officials and labor. Section 3 examines the complexity of pension accounting and critically evaluates the flexibility of accounting standards that provide politicians the means to manage their reported pension debt. The last section discusses how complexity in public financial reporting undermines democratic ideals of public participation and reveals the poverty and frustration found in recent public comment letters submitted to the Government Accounting Standards Board (GASB) concerning public pension accounting. Recommendations for full disclosure of public finances are provided at the end.

2. A Political Perspective on Public Pensions

The thesis that the U.S. pension crisis is partially due to special interest pressure to fund other public services is supported (Faulk, Hicks and Killian 2016). According to the Vic Modugno (2016), a consulting actuary writing for the Society of Actuaries Pension Section News, “Politicians want to provide maximum benefits for minimal taxes. Deferred compensation valued using aggressive actuarial assumptions is one way to do this (p60).” We further suggest that the aggressive political use of pension accounting is kept secret from the average taxpayer through complexity created and perpetuated by professional accounting and actuarial regulatory bodies.

A prevailing, but incomplete, view of pension debt is that liberal tax and spend democrats have made excessive promises to labor over the objections of more fiscally prudent republicans. Empirical research indicates that both parties have supported generous pensions bills (Anzia and Moe, 2016) and the PEW Research Center (2014) reports that unfunded state and local pension debt has been steadily increasing nationwide since 2000. This was confirmed by our own analysis of 126 public pension plans in 49[1] states during the years 2001-2009. Using data maintained by the Center for Retirement Research at Boston College (Public Plans Database, 2013) and data on the political affiliations of the members of state legislatures drawn from the United States Census Bureau (U.S. Census Bureau, 2012), our results show a steady increase in average unfunded pension debt regardless of which political party controlled the state legislature (see appendix A). Our explanation for this increase is based on prevailing economic theory that assumes people, including politicians and employees, are rational utility maximizing economic individuals. Both politicians and employees seek to maximize and ensure continuity of their respective revenue streams. Politicians achieve this through re-election while employees

[1] Nebraska does not have a bicameral structure and was excluded from the analysis.

seek legally binding contracts (Bellante and Long, 1981). Politicians understand that voters will re-elect politicians whose goals and interests seem most congruent to their own. To that end, politicians invest in public goods and services they think voters value, such as roads, education and healthcare. However, goods and services are costly and must be paid for through fees and taxation that are contrary to the interests of the taxpaying public, many of whom are voters. The need for taxes is based on the current budget which is customarily prepared on a modified cash basis under governmental generally accepted accounting principles (GAAP). State and local government must generally balance their budgets so that expected cash receipts will equal appropriated expenditures plus the carryover fund balance. This budgetary system incentivizes politicians to utilize ‘off-balance sheet’ financing mechanisms that enable the acquisition of resources without an equal outlay of cash plus recorded debt. Rent is a common off balance sheet financing mechanism because it acquires an expensive asset, such as a building, for use in exchange for a relatively small periodic cash outlay. Regardless, the purchase of public goods creates goodwill among voters and enhances politicians’ chances for re-election.

Labor is a critical resource that politicians must acquire to achieve their goals. Traditionally, payroll is the ‘sacred cow’ that all managers, including politicians, must pay in cash before any other expenditure because without labor, the organization and all its resources stop functioning. This relationship has often created friction between management and labor as compensation demands encroach upon previous cash commitments made by managers. To help resolve this impasse, politicians may offer pecuniary benefits to labor such as better working conditions, company vehicles, travel, and promises of future payment in the form of bonuses, retirement and other post-retirement benefits. Politicians should prefer future payments to labor over current payments because future payments are a form of off balance sheet financing that does not affect the current budget. Deferred compensation can appear in many forms, but defined benefit pension plans have become a widely accepted and institutionalized form of deferred compensation in government. These plans also have a number of features that make them attractive negotiating instruments for politicians and labor alike.

Pensions as off-budget public financing

Defined benefit (DB) plans provide politicians a flexible means of financing labor resources off-budget. In its simplest form politicians acquire labor for payment at a future date. DB plans appeal to labor because they typically promise annuity payments for the life of the individual. Since labor is rational, they would prefer cash payment, but a contractual or constitutional guaranteed payment for life is very appealing to security conscious wage earners. In order to secure the guarantee, labor may also demand that politicians establish sinking funds to finance the promised future payments and place those resources in a separate entity (trust fund) outside the reach of future politicians who may gain office. This off-budget arrangement thus serves the purposes of both labor and politicians and become an indispensable tool in labor negotiations. Control of the trust fund also becomes another feature which can be negotiated. Taxpaying voters, who ostensibly are monitoring the activities of politicians, should become aware of these contracts and lobby for and obtain assurances that the contracts are fair and equitable. To this end, actuaries provide the government estimates of projected benefit obligations (PBO) and the annual required contributions (ARC) necessary for the sinking fund prepared in accordance with actuarial standards of practice (ASOP). Auditors subsequently provide the public assurances that financial disclosures are audited in accordance with generally accepted government auditing standards (GAGAS). Professional external actuary and auditor services are traditionally selected and paid by the managers of the pension trust fund. To the extent that all parties operate in good faith under enforceable contract provisions, and the actuarial estimates prove to be reliable indicators of future performance, the rights of all parties named so far appear reasonably protected and the system appears sound. However, even the best laid plans may go awry when unexpected events happen.

Nassim Taleb (2007), a bestselling author, hypothesized that rare unexpected events, called as ‘black swans,’ may occur with unpredictable consequences. The best estimates of the future are still only guesses and even under the best of circumstances, there always exists a chance of a highly improbable event occurring. Statistically, these events are characterized by the asymptotic tails found in actuarial probability distributions. Whether the financial crisis of 2009 counts as a black swan, or not, may be debatable due to the frequency of financial crashes. The so called ‘Austrian school’ of economic thought maintains that political tinkering with interest rates and the money supply will inevitably result in cycles of booms and busts (Oppers 2002). Keynesian theorists on the other hand, maintain such measures are necessary to prevent recessions and depressions. Such arguments are beyond the scope of this paper and we are not advocating or dismissing any explanation. We simply point to the observable evidence that market returns fluctuate creating risk for expected rates of return. Since public pensions are guaranteed by governments with a low risk of default, there is an argument that the underlying assets should be invested in similar low risk instruments. This is the position taken by proprietary credit agency models of pension debt.

Politicians have electoral incentives to show taxpayers they can accomplish their goals with a minimum amount of expenditures. Budgeted pension contributions are generally guided by the actuarially calculated minimum required contribution (ARC). Therefore, politicians have an incentive to lower their ARC if possible. This can be accomplished by a variety of actuarial methods discussed later in the paper, such as changing the expected rate of return on plan assets and/or the discount rate used to value liabilities. Higher estimated future earnings reduce the need for current cash contributions, so higher expected rates of return result in lower ARCs. If the expected rates of return fail to materialize, the accumulated unfunded pension debt grows. Therefore, the growing balance of unfunded pension debt over the last decade calls into question the actuarial assumptions used to calculate the ARC and PBO, as well as the willingness of politicians to currently fund them.

Government officials hire actuaries to develop assumptions and calculate the estimated ARCs that must be reported under government GAAP and in many states. They also hire the auditors to attest to the reliability of these calculations. Having multiple expert parties involved and many complex moving parts in the pension calculation helps to diffuse responsibility for any errors in judgement and masks the inherent conflict of interest created by having paid auditors and actuaries working for government officials rather than the public. Regulation and professional codes of conduct are expected to mitigate this risk, but compliance is difficult to ascertain in such complex and long term transactions as defined benefit pensions. For example, outside observers might suspect that one obvious source of error might be using unrealistic expected rates of return, but the Society of Actuaries disagrees (Schilling, 2016). Their studies have determined that discount rates are probably not the driving force behind pension underfunding. According to Schilling (2016), there are many possible sources of error. Case closed, nothing to see here, please move along. Such reports should be viewed with skepticism. The resistance by actuaries to criticism of aggressive assumptions has been extraordinary, as evidenced by the recent censoring of a report by the American Academy of

Actuaries and the Society of Actuaries own task force (Burr, 2016). The accounting profession, for its part, relies on the work of these specialists for the credibility of pension calculations (see the yellow book, GAO, 2011, para 6.40) and itself has a history of promulgating opaque reporting standards with so much flexibility that the former chairman of the Governmental Accounting Standards Board (GASB) claimed they amounted to no standard at all (GASB 27, 1994).

3. Complexity in Public Pension Accounting Standards

Standard setting for public pensions has been contentious from the beginning. The initial pension standards were likely a response to a 1978 Pension Task Force Report on Public Retirement Systems (U.S. GPO, 1978) that determined stakeholders were often unaware of actual pension costs. In 1986, GASB issued Statement No. 5[2] that prescribed some common disclosure requirements so users could assess the funded status of public pension plans using a common approach. The Chairman of the GASB at the time, Mr. James Antonio, dissented because the attribution approach used for funding purposes was not required for both accounting and disclosure. To be clear, we agree with Mr. Antonio, in that the same attribution method used for calculating the ARC should be used for public disclosure of the liability. The Board updated the standards in 1994 with GASB 25[3]. GASB 25 applies to the pension trusts while GASB 27 applies to the pension disclosures by employers. Again, Mr. Antonio dissented, citing a litany of objections related to the flexibility in allowable accounting. It is also clear from the discussion in the standards that Chairman Antonio believed internal users were primarily driving the process. According to the discussion, Mr. Antonio was concerned that the number of attribution methods allowed under the standard amounted to no standard at all. The standards allowed multiple attribution methods and enormous flexibility in the assumptions used for calculating required contributions. Along with generous amortization regimes, government managers could defer recognition of certain compensation agreements, <u>even employee termination benefits</u>, for up to 40 years.

[2] GASB5 (1986). Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Government Employers

[3] GASB25 (1994), Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans, and GASB 27 (1994), Accounting for Pensions by State and Local Governmental Employers

Attribution Methods

Under GASB 25 and 27 (1994), state and local governments were allowed to use one of six actuarial cost methods to determine their actuarial liability, or the present value of compensation that is deferred to future years. These included entry age, frozen entry age, attained age, frozen attained age, projected unit credit or the aggregate actuarial cost methods. The method of attribution is important because it has a direct bearing on the value of the resulting pension liability, funded status and required contributions. Under unit credit approaches, the projected benefit is based on a consistent formula such as total service periods times some percentage of future salary times the fraction of service earned to date. Assumptions regarding the projection of service periods, percentages allowed and future salaries vary. The entry age methods calculate the benefit on a level basis of earnings or service between the beginning of employment (entry age) and the assumed retirement date. Again, assumptions of entry age, demographics and economics may vary. Under the unit credit approaches contributions tend to increase (as a dollar amount or percentage of pay) as employees near retirement, whereas the amount or percentage of pay contributed under the entry age approaches tends to stay even throughout an employees' tenure. Actuarially, this is because a 'unit credit' of retirement benefits attributed to a particular period has a lower present value the further away in time it is from when the benefit is actually paid. Attained age methods have the same actuarial liability as the unit credit methods, but different contribution rates. The standard contribution rate for attained age methods is based on the average age of active members as a group, rising or falling as the average age of the group increases or decreases. The frozen methods allocate the excess of the projected benefits over the sum of the assets plus a frozen unfunded liability on a level basis between the valuation date and assumed exit of a group as a whole, not as the sum of individual allocations. The aggregate methods use a technique similar to the frozen methods, but do not include the frozen unfunded liabilities. The aggregate method is unique in that the unfunded portion of benefits, even those from past service, are allocated as future normal costs resulting in no current net unfunded liability.

Underlying Pension Assumptions

In addition to the methods used to project future liabilities, there are a number of associated assumptions regarding expected investment rates of return, contribution rates, rates of projected salary increases, inflation rates and so forth. The difference between the present value of the projected liability and fund investments is the net funded position of the pension plan. All actuarial approaches require the discounting of projected liabilities to the present value using a settlement rate and an assumption of the expected investment rates of return in contributed funds. Typically, these are the same rate, but they may be selected independently. Obviously, the higher the assumed rates are, the larger the investment pool grows and the lower the projected liabilities are. Special asset valuation (smoothing) methods are also frequently used to strike a balance between an investment portfolio's current market value and a theoretically more realistic value that accounts for volatile securities held for long periods. GASB standards simply state that asset valuation should reflect some function of market value, which may include cost, current market value or an average of market values over several years, based upon "the judgment of those familiar with the circumstances" (GASB 25 para 140, 1994). Differences between actual and assumed rates of return, or changes in future benefits, result in actuarial gains and losses that are amortized into expense and contributions rates over time. The intent is to smooth differences between actual and assumed results, creating a stable pattern for contributions. Flexibility in accounting methods and assumptions create the opportunity for employers to reduce or eliminate current required contributions, creating a "contribution holiday". GASB standards generally allowed this, within limits, and again, 'as appropriate in the judgment of those familiar with the circumstances'. It was not until after the 2009 financial crisis when the market value of pension assets dramatically declined that the GASB would consider more conservative changes to the standards. In June 2013, the Governmental Accounting Standards Board (GASB) issued Statements No. 68[4] and 67[5]. However, even these standards have been criticized as complicated, burdensome and ineffective (Eucalitto, 2013; Biggs, 2011). For example, these new standards prescribe the calculation of a blended discount rate that we characterize as a sliding scale where better funded plans are allowed to use higher discount rates. Since funded ratios vary, plan discounts rates will vary, resulting in reduced consistency and comparability of reported pension debt. This reduces the usefulness of the disclosures to investors and creditors and creates a market for proprietary credit ratings models. The now disbanded Joint American Academy of Actuaries/Society of Actuaries Pension Finance

[4] GASB 68, *Accounting and Financial Reporting for Pensions, an amendment of GASB Statement No. 27*

[5] GASB67, *Financial Reporting for Pension Plans, an amendment of GASB Statement No.25*

Task Force disagreed with the discount rate provisions in GASB 67 & 68 claiming that since public pensions are certain to be paid, they should be discounted at a default free rate (Comment Letter 44, GASB 25 Exposure Draft, American Academy of Actuaries Dated October 4, 2011). Using a lower risk free rate would increase the size of the pension debt to possibly unacceptable levels from a political point a view, particularly if the public were told in an understandable way how large these debts were and what their implications are for future taxes and intergenerational equity. We recognize that there are alternative means the federal government may use to address the deficit in state and local pension funding, but those speculations are beyond the scope of this paper.

4. The Public Interest and Public Pensions

In a society that values democracy, policy makers should be accountable to those affected by the rules they promulgate. This requires institutions and processes to gather input or feedback from the citizenry that serves as the foundation upon which the policy makers create and modify policy. When the voting citizenry cannot evaluate an issue because of its complexity and the need for specialized knowledge, society has established professions to act in their stead, often conferring monopoly market status through licensing in exchange for implicit promises to act in the public interest (Kultgen, 2014). In this respect, the accounting profession has a mandate to administer and resolve complex accounting issues, such as public pensions, on behalf of the public and with their interests in mind. Democratic principles also dictate that the accounting profession has a responsibility to determine what the public interest is through an honest and deliberative process. Drysek (2011) defines deliberation as reciprocal communication that reflects on preferences, linking specific claims to general principles, in such a manner that all sides can understand what is being communicated. While doctors may not always explain the nuances of a particular disease and treatment to patients, they understand the patients' right to know and adjust their communication accordingly. Likewise, average taxpayers cannot be expected to understand the nuances of complex accounting and actuarial methods, so it is incumbent upon state boards of accountancy and related professional organizations to ensure public pension information is appropriately communicated to taxpayers.

The accounting profession is fully aware of their responsibilities under its social contract. The stated mission of the GASB is, in part, to *"…guide and educate* *the public, including issuers, auditors and users…through a comprehensive and independent process that encourages broad participation…"* (FAF 2013, 2). Furthermore, GASB Concept Statement No. 1 (1987) specifically identifies taxpayers as a defined user group of governmental financial reports and says that the reports should be understandable. Therefore, not only does the public have a right to know what is taking place with their public finances, it has a right to expect understandable, (i.e. clear and appropriate) disclosure from the public accounting profession.

According to Bushee, Gow & Taylor (2016), linguistics complexity consists of two latent components, obfuscation and information. The obfuscation component increases information asymmetry and by imposing cognitive burdens of the reader. This is supported by Li (2008), who found a positive relation between the use of complex language and poor performance in financial disclosures. The implication of this work is that the instrumental use of linguistic complexity slows market reactions to otherwise valid information. When this concept is applied to the complex technical jargon associated with pension disclosures, it suggests that some of the complexity in pension disclosures may have an instrumental purpose to delay taxpayer understanding or induce an intellectual stupor among the public.

GASB Comment Letters

The GASB is aware of public criticism against its pension standards, yet fails to appropriately respond. A review of public comment letters submitted during the policy formulation period for GASB Statements Nos. 67 and 68 reveal a disheartening absence of participation by average citizens and a noticeable level of frustration by those who do. We retrieved 1,024 comment letters from the GASB.gov website and coded them into NVivo qualitative research software by submission wave, letter number and interest group. These results indicated that that only 74 letters were submitted by individuals or groups representing the general citizenry (see appendix B). The results are consistent with previous research indicating low public participation in accounting standards setting by individuals (Jorissen, LyBaert, Orens & van der Tas, 2013; Yen, Hirst & Hopkins 2007; Ryan, Dunstan and Stanley, 1999; Kenny and Larson, 1995; Tandy and Wilburn, 1992). This documented lack of participation by the citizenry in accounting standard setting speaks to the inability of the profession to hear a representative cross section of concerns about public pension disclosure among the voting public. As shown below, a pattern emerged among the few citizens who did submit comment letters to GASB, revealing a persistent level of frustration with the complexity of disclosures.

“Citizens desperately need disclosure of pension liabilities in the audited financial balance sheets, rather than having such information shunted off to footnotes, coated with opaque language.” Comment Letter 46, GASB 27 Exposure Draft, by The Citizens for Sustainable Public Pension Plans, Dated Sept. 22, 2011.

“That is, deficiencies in GASB GAAP make it impossible for the basic financial statements prepared using these standards to present in any meaningful way the true scope of the form of the commitments being undertaken. As a result, it is still realistically impossible for even the most sophisticated user of such reporting to independently determine and judge a public sector entity’s true financial condition.” Comment letter 199, GASB 27 Exposure Draft, by Institute for Truth in Accounting. Dated October 13, 2011.

“The County’s financial statements –and those of the Mendocino County Employees Retirement Association (MCERA) –were significant barriers to my understanding my county’s finances. Because of my training and experience, and motivation, I was able eventually to “penetrate” those statements–although significant frustrations remain. But even with my background it took many hundreds of hours to do so. I had to learn far more about governmental accounting and reporting and dig much deeper than I think should be required.” Comment Letter 58, GASB 27 Exposure Draft, by YourPublicMoney.Com, Dated Sept. 27, 2011.

To the extent that such comments are representative of taxpayers’ experience reading public pension disclosures suggests that the GASB’s standards have failed to adequately ‘guide and educate the public’ about this accumulating debt.

The lack of participation by institutional investors (7 letters) is also revealing of the irrelevance of GASB disclosures. Investors and creditors appear to rely on credit ratings agency models that adjust pension debt using consistent and comparable discount rates and attribution methods (Moody, 2013). Fitch Ratings was the only credit rating agency that commented on the GASB statements and while they did not advocate a specific method or discount rate assumption, they supported a solution that would minimize the potential for managerial opportunism in the application of accounting standards, thereby increasing comparability among financial statements.

“Selection of a discount rate is among the factors to which the level of the unfunded pension obligation is most sensitive…However, the selection of a discount rate may be driven more by the urge to favorably change the unfunded obligation rather than by long-term investment experience.” Comment Letter 12, Invitation to Comment, By Fitch Ratings. Dated August 19, 2009.

Summary

Our analysis suggests that politicians are instrumental in their use of public pensions to satisfy the demands of labor while retaining the flexibility to choose when to actually fund them. Pressure from other interest groups for spending priority crowds out prudent funding and arcane accounting disclosure effectively hides this result from average voting taxpayers. It is only after required cash payments for pension benefits create a crisis by cutting into basic services that the public awakens to the consequences of the accumulating debt. This result is no better than a cash basis ‘pay-as-you-go’ accounting policy. The accounting profession has failed to provide the public with understandable information by promulgating flexible pension accounting disclosures that are so complex the average taxpayer is unable to understand their meaning. If we follow the seminal reasoning of Watts and Zimmerman (1979), where accounting theories are created to satisfy a market for political justification, it seems that professional accountants and actuaries are willing to supply convoluted theory to politicians that enables them to give taxpayers immediate benefits while delaying and obscuring the costs. As long as this game continues, the public pension debt will continue to accumulate.

Recommendations

Some reviewers criticize our comments for not providing a solution, so we respond by claiming that useful, relevant and understandable disclosure is its own solution. Debt is debt, whether it is called an arrearage, lease, loan, note, liability, obligation, mortgage, debenture, encumbrance, bond, IOU, or in the case of pensions, simply a deferred debit. Furthermore, we believe that <u>any</u> debt, including public pension debt, incurred by any public official, should be included in a public budget that is voted upon by the citizenry. This would require full accrual accounting for public finances, a concept championed by former New York Congressman, Joseph Dioguardi (2010), and many others.

Simplicity should be the standard for public finance disclosure. Standard setters should stand by the citizenry from whom they derive their authority, and by professional ethical principles, in facing the issue of unfunded public debt, or quit making claims they operate in the public interest.

If the profession cannot, or will not adequately respond, it is incumbent upon citizens to petition the U.S. Congress to have public pensions regulated by the Consumer Finance Protection Bureau. The public is a consumer of public goods and deserve the same protections as those buying a house or automobile. Consumer protection laws such as the Truth in Lending Act, the Consumer Credit Protection Act, and Regulation Z have a common feature called a "Total Payoff and Payment" provision. This type of provision requires explicit disclosure of the current loan payoff amount and the total <u>undiscounted</u> payments that would be made over the life of the loan if only minimum required payments were made. These payoff and payment provisions are usually highlighted and presented in simple English, free of technical jargon, so that an average citizen with only the minimum required public education can understand the consequences of entering into the agreement. Any changes to interest rates or adjustments to the outstanding balance must also be agreed to by the consumer. This would require all actuarial changes to pensions to be disclosed within the current budget and voted upon by the citizenry. Perpetuating public secrecy through complexity subverts the spirit of full disclosure of public finance and invites future financial non-performance. Politicians and pensioners alike should consider the words of the American economist, Michael Hudson (2012) who stated, *"Debts that can't be repaid, won't be"* (Hudson, 2012, p19). Alternatively, future generations of Americans may simply vote NO to economic peonage.

Appendix A. Regression model – Upper Chamber – Republican Controlled

Adjusted R^2 = .225 F-Statistic 21.285 (.000) VARIABLE	Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t-value	Sig.
(Constant)	74.621	6.398		11.664	.000
R_Hi_1	1.997	.905	.062	2.207	.028
PUC	-11.058	1.347	-.228	-8.209	.000
AGGREGAT	5.551	2.108	.085	2.633	.009
ERISA	8.053	2.300	.118	3.501	.000
ARCPCT	.032	.010	.092	3.234	.001
INVCNCL	6.331	.976	.187	6.483	.000
LNLIABS	.928	.372	.072	2.492	.013
T2002	-5.170	1.923	-.100	-2.689	.007
T2003	-7.648	1.903	-.151	-4.019	.000
T2004	-10.130	1.899	-.201	-5.334	.000
T2005	-11.217	1.900	-.223	-5.905	.000
T2006	-11.779	1.909	-.231	-6.171	.000
T2007	-9.948	1.900	-.197	-5.236	.000
T2008	-13.506	1.898	-.266	-7.115	.000
T2009	-16.934	1.938	-.325	-8.738	.000

N=1024

Key for Appendix A

Funded Ratio= Ratio of plan assets to plan liabilities (reported actuarial values)

R_Hi_1= Indicator variable set to one if a republican Party has majority vote in a state's upper and lower legislative chambers.

PUC= Indicator variable set to one if a plan uses the Projected Unit Credit actuarial cost method.

AGGREGAT= Indicator variable set to one if a plan uses the aggregate actuarial cost method.

ERISA= Indicator variable set to one if a plan was established after 1974

ARCPCT= Percentage of Annual Required Contribution paid during the year.

INVCNCL= Indicator variable set to one if a plan has a dedicated investment board or uses financial advisors in making investment decisions

LNLIABS= Natural log of plan liabilities.

T200X= Indicator variable for fiscal year ended

Appendix B. Counts of Comment Letters regarding GASB Statements 67 and 68

User Group	Submission Wave								TOTALS	
	ED25		ED27		PV		IC			
	N	%	N	%	N	%	N	%	N	%
GFO	20	2.0%	51	5.0%	35	3.4%	27	2.6%	133	13.0%
FUN	9	0.9%	36	3.5%	55	5.4%	25	2.4%	125	12.2%
EMP	7	0.7%	151	14.7%	40	3.9%	10	1.0%	208	20.3%
CIT	4	0.4%	25	2.4%	27	2.6%	18	1.8%	74	7.2%
MEM	1	0.1%	347	33.9%	11	1.1%	6	0.6%	365	35.6%
INV	2	0.2%	3	0.3%	2	0.2%	1	0.1%	8	0.8%
ACT	7	0.7%	17	1.7%	22	2.1%	22	2.1%	68	6.6%
CPA	8	0.8%	19	1.9%	5	0.5%	11	1.1%	43	4.2%
TOTALS	58	5.7%	649	63.4%	197	19.2%	120	11.7%	1024	100.0%

N= 1024

Key for Appendix B
Submission wave:
IC = Invitation to Comment,
PV = Preliminary Views,
ED25 = Exposure Draft of changes to Statement No. 25 (GASB67)
ED27 = Exposure Draft of Statement No. 27 (GASB68).

User groups:
GFO = Government finance officers
FUN = Pension fund managers
EMP = Employers
CIT = General citizenry
MEM - Plan members
INV - Investors
CPA - Professional Certified public accountants
ACT – Professional actuaries

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