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"GASB Won't Let Me" – A False Objection to Public Pension Reform

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Professor Costrell has both an academic and policy-making background. His academic career has featured seminal publications on the economic theory of educational standards, income distribution and testing, school finance litigation, and teacher pensions. These have appeared in the American Economic Review, the Journal of Political Economy, and Education Finance and Policy, as well as general interest publications, such as Brookings Papers on Education Policy and Education Next. He has also written commentaries for the Wall Street Journal and Education Week.

From 1999 to 2006, Dr. Costrell served in major policy roles for three governors of Massachusetts, including policy research director and chief economist, with a particular focus on education policy as that state's landmark reforms were implemented. As education advisor to Governor Mitt Romney, he helped develop the governor's comprehensive proposal for a second round of education reform in 2005, and also led the reforms of the state's district and charter funding formulas. He represented the administration on the Public Employee Retirement Administration Commission (2001-03).

Professor Costrell joined the faculty at the University of Arkansas in August 2006, and was the founding graduate director of the Ph.D. program in Education Policy. Professor Costrell taught economics at the University of Massachusetts in Amherst, from 1978 to 2000. He received his B.A. in economics from the University of Michigan in 1972 and his Ph.D. in economics from Harvard University in 1978.

Executive Summary

True public pension reform replaces traditional Defined Benefit (DB) plans with structures that tie benefits more closely to contributions. The rationale for structural reform includes fiscal responsibility, labor market efficiency and equity among professionals with varying career paths. Defined Contribution, Cash Balance and Hybrid plans are all proposals that tie benefits more closely to contributions to achieve these goals. In the legislative arena, such proposals face a set of objections commonly called Transition Costs – claims that structural reforms will raise employer costs in the short run, even if they lower them in the long run. Advocates for traditional pensions argue that it would be especially unwise to incur these Transition Costs in times of fiscal duress, and legislatures, with short time horizons and balanced budget requirements, are deterred by these claims from undertaking structural reform.

This paper examines the most common of these claims, that structural pension reform requires an *acceleration of payments to amortize the old plan's unfunded liability*. The claim has three components:

(i) A rule set by the Government Accounting Standards Board (GASB) requires an accelerated amortization schedule for the Annual Required Contribution (ARC) if the old DB plan is closed to new members;

(ii) GASB rules for the ARC determine state funding policy, thereby driving actual contributions; and

(iii) The GASB rule for closed DB plans is sound policy, since covered payroll shrinks, ending the basis for a rising schedule of amortization payments.

This paper's main findings are these:

- The first claim is true. GASB accounting standards unambiguously require a shift in amortization methods from "level percent of payroll" – a back-loaded method – to "level dollar" if the old DB plan is closed to new members. This shift in amortization methods accelerates the amortization schedule for the ARC calculation.
- The second claim is false. GASB sets standards for financial reporting; it does not determine funding policy and does not claim to. Pension plans are required to report the ARC for comparison with the actual contribution, but the actual contribution is set by each state's statutory authority – either the legislature or the pension board, if that authority has been delegated. These authorities are not bound by GASB accounting standards in setting funding policy, and actual contributions often differ from the ARC.
- The third claim is false. GASB's rule assumes that amortization payments must be based on the payroll of DB members alone, a base that shrinks after closing the plan. However, states can and

> do levy these payments on total payroll – old and new plans alike – and with sound justification. Total payroll growth is unaffected by closing the DB plan, so there is no policy reason to change amortization methods. The rationale put forth by GASB for "level percent" amortization, based on a growing payroll, continues to be satisfied by total payroll. The GASB rule for closed plans, based on payroll of DB members alone, does not seem to anticipate the total payroll approach.

Reform-oriented states have based amortization payments on total payroll as they adopt new plans and continue to use the level percent amortization method. Other states considering reform may follow their lead, undaunted by the false claim that GASB rules require them to accelerate amortization payments. In fact, GASB intends to drop the rule, along with the entire ARC construct, under GASB's proposed revisions to its standards. Regardless, neither the rule itself, nor, more importantly, the underlying rationale for the rule, requires accelerated payments.

The decision on scheduling amortization payments on the unfunded accrued liability (UAL) is a financial policy decision, not much different from the decision on scheduling debt service payments on ordinary debt. How to structure future benefits is a separate policy decision. Pension reform proposals should be evaluated on their own merits and not confused with amortization schedules. Amortization pays for past debts; pension reform lays a path toward a responsible future.

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Introduction: The Case for Pension Reform and Transition Costs Arguments Against It

The last few years have seen a wave of activity in many states to shore up underfunded public pension systems and cut costs (NCSL, 2012b). Legislative action has fallen broadly into two categories: (1) paring back benefits or raising contributions within the existing framework of traditional Defined Benefit (DB) plans; and (2) structural reform to alter the framework in a way that ties benefits more closely to contributions, through Defined Contribution, Cash Balance and Hybrid plans. The case for the latter path – structural reform – has three prongs.

First, tying benefits more closely to contributions can provide greater protection against fiscal backsliding than can simply changing parameters within the current system (Laura and John Arnold Foundation, 2011). Such reforms can reduce opportunities for members and their employers to "game" the system to expand the gap between benefits and contributions;[1] they can reduce political incentives to underfund the system, shifting contributions to the future; and they can make it harder to ratchet benefits back up with enhancements to the DB formula if and when current budgetary difficulties recede.

Second, structural reform can enhance labor market efficiency. Research on teacher pension plans shows they carry strong and peculiar incentives for arbitrarily timed retirement decisions, creating potential labor market inefficiencies[2] (Costrell & Podgursky, 2008 and 2009).

Third, traditional DB plans generate stark inequities by distributing benefits that are incommensurate with contributions. Rewards are often concentrated on those who serve in one system until their mid-50s and then leave, while effectively punishing career-switchers and mobile professionals by conferring benefits that are worth far less than the contributions made on their behalf (Costrell & Podgursky, 2010a and 2010b).

The fundamental problem with current systems – underlying the fiscal, efficiency and equity shortcomings – is the failure to tie benefits to contributions (Costrell & Podgursky, 2011). The basic theme of structural pension reform, therefore, is to tie benefits to contributions at the individual level. This can be done in a variety of ways. Defined Contribution (DC) plans are the most obvious, but not the only way. Cash Balance and Hybrid plans, discussed later, are equally, if not more compelling alternatives.

Most of the current wave of legislation has ignored structural issues and merely changed the parameters of existing plans (albeit often dramatically so). Thus, retirement ages have been raised, early retirement penalties increased, vesting periods lengthened, look-back periods for final-salary averaging widened, Cost-Of-Living-Adjustments (COLAs) pared back and employee contributions raised. While these measures reduce employer costs, some of them may have worsened structural problems, e.g., widening inequities between long- and short-termers (Costrell & Podgursky, 2011).

In some states structural reforms have been proposed and even enacted (NCSL, 2012a), as discussed below. In most cases, however, these efforts have been vigorously and successfully resisted by public employee unions, pension funds and national pension fund organizations. These groups appear more staunchly opposed to fundamental reform than to cutbacks in the existing formulas, so the latter have most commonly been enacted.

1) An example is "pension-spiking," the practice of raising salaries right before retirement to increase the pension.

2) The incentives lead some individuals to continue working solely for the pension, whether or not they are still suited for the job. Beyond a certain point, they lead others to prematurely retire, so as not to sacrifice years of pension benefits.

There are probably unstated reasons, as well as the stated arguments, for the greater resistance to fundamental reform.[3] However, this paper will take the stated arguments at face value.

The arguments that face pension reformers across the nation prominently feature Transition Costs, the subject of this paper.[4] While taking various forms, what these arguments have in common is the claim that proposed reforms will raise costs in the short run. Thus, even if the reforms offer long-term benefits, including lower costs, rationalized incentives and reduced inequities, advocates for traditional pensions argue that it would be unwise to undertake these reforms in times of fiscal duress because of Transition Costs. For example, a widely cited policy brief by the National Institute on Retirement Security (NIRS) concludes that a transition to DC would "increase costs to the employer/taxpayer at exactly the wrong time" (NIRS, 2008).[5] Legislatures, with short time horizons and balanced budget requirements, are deterred by these claims (backed up by legislative fiscal notes) from undertaking structural reform.

The specific claim examined here is that pension reform requires *accelerated amortization of unfunded liabilities*, because of an accounting rule set by the Government Accounting Standards Board (GASB) in 1994. The rule is triggered by closing the DB plan to new members. Since the number of plan members will decline after it is closed, the DB payroll will shrink. Since the GASB rule only allows the amortization schedule to rise with the payroll of DB members, closing the plan has the effect of barring a rising schedule, thereby forcing an acceleration of amortization.[6]

The significance of this argument is illustrated by the summary of recent changes in state pension plans by Ronald K. Snell, for the National Conference of State Legislatures (NCSL): "In part, the reluctance to move away from traditional defined benefit plans grew out of concerns about transitional costs… Legacy costs could mean an increased burden of employer contributions for closed plans as their membership falls over time" (NCSL, 2012b).

This paper will (1) explain the claim that GASB requires amortization expenses to rise in the short run and fall thereafter; (2) examine the basis of the claim in GASB Statements 25 and 27; (3) explain why the claim that GASB determines funding policy is false and give examples of both false and true statements of GASB's role; (4) examine the policy rationale for the GASB rule, showing how that rationale is satisfied without changing the amortization method when employer contributions are levied on total payroll, including both old and new plans; and (5) show how reform-oriented states have adopted such a total payroll policy and have maintained the existing amortization method while closing the old DB plan to new members. GASB has not been an obstacle for these states and need not be an obstacle for others.

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3) For example, one might expect pension funds and their national organizations to protect the DB plans they administer against potential replacement by alternative plans they might not administer or that would require retooling. In addition, unions often tend to favor the interests of senior members over junior members, and that would be consistent with opposing such reforms, since DC, Cash Balance and Hybrid plans would stop favoring long-termers over short-termers. Finally, unions and others may believe that benefit cuts to existing plans could be more easily reversed than fundamental reforms, if and when circumstances improve. For example, New York City introduced new tiers with higher retirement age requirements after the fiscal crisis of the 1970s, but eventually the teachers' union negotiated with the city to put the new tiers on the same footing as the old tiers.

4) Other arguments have also been put forth, alleging long-term advantages of current DB systems over proposed alternatives. These are not addressed in this paper.

5) Once the fiscal crisis passes, the political pressure for reform abates, so one is left with the impression that there is never a good time to undertake these reforms.

6) Other Transition Costs arguments include the idea that closing the DB plan shortens the fund's investment horizon and tilts it away from equities toward bonds, reducing returns. These arguments will be addressed in future publications by the author.

As the concluding section explains, the GASB rule will likely be eliminated this year, forcing the separate issues of amortization and pension reform back to their proper place, the policy arena. In the meantime, it is worth examining the GASB-based argument closely, in case the rule is not dropped. This examination is also valuable because it illuminates the pattern of inaccurate and misleading interest group claims that characterize so many of the pension reform debates.

1. The Claim: Accelerated Amortization of Unfunded Accrued Liability (UAL)

In the legislative debate about pension reform, the term "costs" refers to "employer contributions" to the pension fund, the contributions over and above those of the employee. These are the contributions that come directly from taxpayers, typically the school district in the case of teacher pensions, but they also can come from the state (whether or not it is the employer), or both. Transition Costs claims hold that pension reform will alter the time structure of employer contributions, raising them in the short run and reducing them in the long run.

Contributions typically have two components. The first, known as the "normal cost," is the annual cost of *currently* accruing liabilities, as employees earn additional future benefits from additional years of service. The annual contribution of the normal cost is calculated to pre-fund the newly earned future benefits, so new assets equal new liabilities.

The second component, known as the "amortization of the Unfunded Accrued Liability (UAL)," is the object of the claim in question. The UAL is the difference between *previously* accrued liabilities and *previously* accumulated assets.[7] The "amortization payments" are a series of contributions required to pay off the UAL, analogous to a series of mortgage payments to pay off a home loan.

Amortization payments can be structured in two ways. They can be a series of uniform payments during a fixed period of time, just like a conventional 30-year mortgage. Alternatively – and more commonly for pension funds – they are back-loaded, rising over time, but still calculated to pay off the debt by the end of the period.[8]

These two methods are specifically defined by GASB (1994a, 1994b):

> **Level dollar amortization method.** The amount to be amortized is divided into equal dollar amounts to be paid over a given number of years; part of each payment is interest and part is principal (similar to a mortgage payment on a building). Because payroll can be expected to increase as a result of inflation, level dollar payments generally represent a decreasing percentage of payroll; in dollars adjusted for inflation, the payments can be expected to decrease over time. (paragraph 44)
>
> **Level percentage of projected payroll amortization method.** Amortization payments are

7) Alternative terms for "Unfunded Accrued Liability" are "Unfunded Actuarial Liability" and "Unfunded Actuarial Accrued Liability" (UAAL). GASB accepts all three terms for the same concept. See GASB (1994a), paragraph 45, A-6.

8) This description assumes a "closed" period for amortization. Pension funds often use "open" period methods, but this is a secondary consideration here. Newly proposed GASB rules will no longer endorse "open" period methods.

> calculated so that they are a constant percentage of the projected payroll of active plan members over a given number of years. The dollar amount of the payments generally will increase over time as payroll increases due to inflation; in dollars adjusted for inflation, the payments can be expected to remain level. (paragraph 39)

The choice between level dollar and level percentage amortization methods is the crux of the Transition Costs claim examined here. The claim is that if pension reform closes the DB plan, GASB forces those plans that are on a level percentage schedule with rising payments, to shift to a level dollar schedule. This means payments will be higher in the short run than previously scheduled, and then, beyond a certain point, payments will be lower until the end of the amortization period.

The present value of the series of payments is unaffected by the choice of amortization method. In both cases – back-loaded or level dollar – the series of payments, discounted by the assumed rate of return,[9] sums to the UAL, and the method of amortization does not affect the UAL.[10] Stating this formally:

$$UAL_t = PV(AP_{t+1}, AP_{t+2}, \ldots, AP_{t+T}),$$

where the quantity on the left-hand side, the UAL at time t, is constant, and therefore so is the sum on the right-hand side, the present value (PV) of the series of T amortization payments (AP_{t+1}, …). The claim is that pension reform requires a shift in amortization methods, raising the APs up to a breakeven year and then reducing the payments to the end of the amortization period. The payments are accelerated, but the discounted sums of the two series – the size of the obligation – are identical.

The claim that GASB rules force a shift in amortization methods which accelerates payments is made quite commonly. A partial list of states where this objection has been raised against pension reform includes: California, Kentucky, Michigan, and Minnesota as discussed later in this paper. In a few other states, also discussed later, this objection was considered but was found not to be an obstacle to reform.

Typically, the argument is advanced by the retirement system, accompanied by calculations of its consulting actuary and echoed by a legislative report (or fiscal note) on the adverse budgetary impact of the reform, which ultimately kills the proposal. These efforts often draw upon policy briefs and testimony by national organizations, such as the National Institute on Retirement Security (NIRS) and the National Association of State Retirement Administrators (NASRA).

This claim is featured prominently in pension reform debates because it is relatively easy to place a dollar amount on it. Actuaries can readily compute the series of amortization payments under the level dollar and level percentage methods and compare them. In doing so, the higher contributions under level dollar in the near-term years receive prominent attention – especially newspaper headlines – much more so than the out-year savings.

The California Public Employees' Retirement System (CalPERS) provided such estimates in its March 2011

9) The present value depends on the discount rate, the subject of considerable controversy, but that controversy is unrelated to the claim under consideration here.

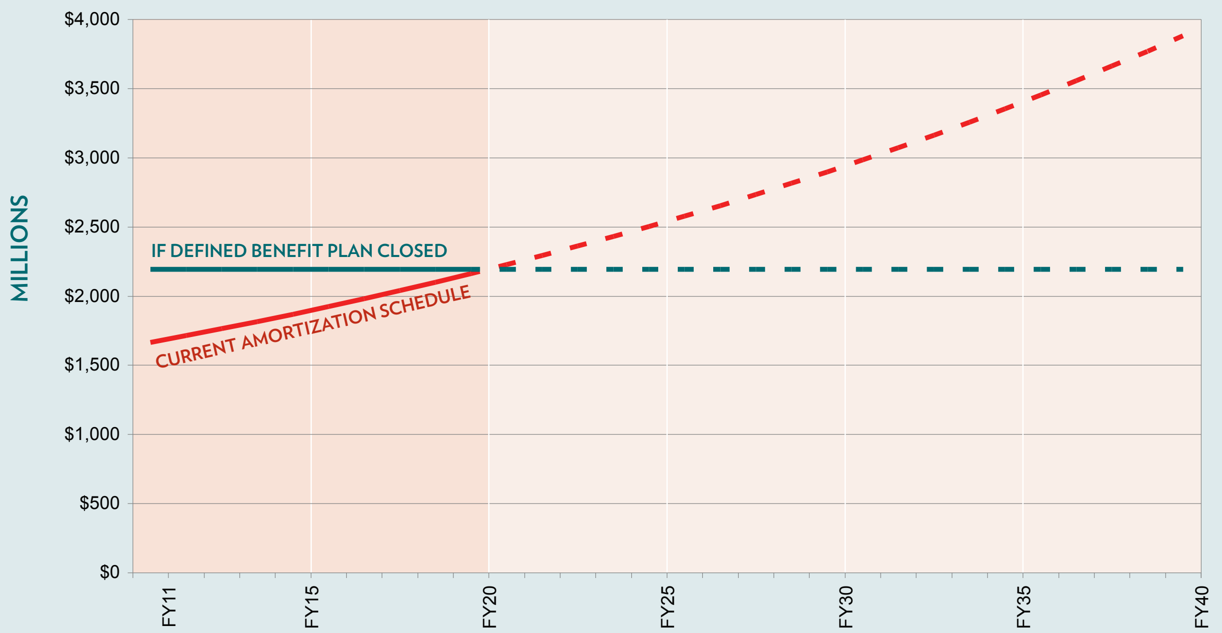
10) Nor does the pension reform itself ordinarily affect the UAL. The previously accumulated assets are obviously unaffected by the pension reform. The previously accrued liabilities also are unaffected in the usual case, where pension reforms apply only to new hires or to future accruals of current employees. If, instead, previously earned benefits are reduced (e.g., COLAs are cut back for current employees or retirees), this would reduce the UAL and the stream of amortization payments, working against the Transition Costs claim of higher payments in the short run.

report, "The Impact of Closing the Defined Benefit Plan at CalPERS" (CalPERS, 2011a). The report compares the current amortization schedule for the state plans, starting at $1,663.8 million and rising about 3 percent per year, with a schedule of level funding at $2,192.8 million throughout. Thus, pension "expense" (a carefully chosen term that will be discussed below) would be $529 million higher in FY2011 than currently scheduled and would continue to be higher (by successively lesser amounts) through FY2020, and "lower afterward."

These amounts are reported in a table covering the first 10 years, where the expense is higher, but omitting the following 20 years, where the expense is lower. Figure 1 depicts the figures reported in the CalPERS table (solid lines) as well as an estimate of the figures excluded from the table for the following years (dotted lines).

fig. 1 **Impact on Pension Expense, California State Plans**

CURRENT AMORTIZATION SCHEDULE VS. CLOSURE OF DEFINED BENEFIT PLAN



Source: *FY11-20, CalPERS 2011; FY21-40, author*

In this fashion, the alleged Transition Costs – higher expenses in the short run – have been quantified in state after state, deterring lawmakers from closing down existing plans.[11] The dollar amounts are large for plans that have large UALs. As Keith Brainard, Research Director of NASRA recently put it, "Generally speaking the more underfunded a plan is, the more expensive it is to try to switch."[12]

11) Such dollar estimates are also reported in Nevada, Kentucky, Minnesota and elsewhere.

12) See presentation at National Conference of State Legislatures (NCSL) Fall Forum, 2011[Video File]. Retrieved from www.ncsl.org/issues-research/labor/a-model-for-state-pension-reform.aspx www.youtube.com/watch?v=0tnfWO9wSbE

2. What Is GASB and What Does it Say About Amortization?

The Governmental Accounting Standards Board is a non-government entity that sets standards *for accounting and financial reporting* of state and local governments, as its name denotes (GASB, 2012). Established in 1984, GASB is an operating component of the Financial Accounting Foundation, the nonprofit industry group that also includes the Financial Accounting Standards Board (FASB), which sets accounting and reporting standards for the private sector. Although GASB standards are not federal laws and GASB has no enforcement authority, the standards are recognized by state and local governments as authoritative (sometimes by statute). As a result, the Comprehensive Annual Financial Reports (CAFRs) of government entities invariably follow GASB standards. Actuarial reports of public pension plans will also generally include GASB disclosures.

GASB periodically issues "Statements" delineating the standards in various areas of financial reporting. There are two closely related Statements on public pension accounting: one for pension plans (Statement 25, GASB 1994a) and one for employers (Statement 27, GASB 1994b). These Statements were issued simultaneously in November 1994 (as discussed later, new Statements are in the works).

The titles of these Statements are informative: "Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans" and "Accounting for Pensions by State and Local Government Employers." The subject of these Statements is financial reporting and accounting. They provide standards that specify how the CAFRs of public pension funds and public employers should be structured and what content they should convey on matters relating to pensions. The first sentence of each Statement is explicit: "The objective of this Statement is to enhance the understandability and usefulness of pension information included in the financial statements of state and local governmental pension plans [Statement 25]/employers [Statement 27]." (paragraph 1)

In Statement 25 (GASB 1994a), GASB begins delineating its standards by specifying the structure and content of the plan's two basic "Financial Statements": the "Statement of Plan Net Assets" (the balance sheet) and the "Statement of Changes in Plan Net Assets" (the income statement). The Statement goes on to specify the content of the "Notes to the Financial Statements." A pertinent item here is: "Funding policy, including a brief description of how the contributions of the plan members, employer(s), and other contributing entities are determined (for example, by statute, through an actuarial valuation, or in some other manner) …" (paragraph 32.c.2) Here and elsewhere GASB is clear that it does not set funding policy; it is set either directly by statute or by the statutorily authorized entity (e.g., a pension board) that may or may not use an actuarial valuation, let alone any specified actuarial method.

Statement 25 specifies two other required elements of the financial report (for a total of four) under the heading of "Required Supplementary Information," which is the pertinent section for the Transition Costs claim. The two elements are the "Schedule of Funding Progress" and the "Schedule of Employer Contributions." These are the elements of the financial report that use actuarial methods. Consequently, this is the section of Statement 25 that sets GASB standards for the actuarial calculations, known as the "Parameters." Paragraph 36 begins by setting the context for the Parameters: "*For financial reporting purposes*, all actuarially determined pension information should be calculated in accordance with this paragraph…" [emphasis added] Some of the Parameters refer to the methods used for calculating actuarial liabilities and actuarial assets, but the relevant material here is in paragraph 36.f , which specifies the calculation of the "Annual required contributions of the employer(s) (ARC)."

It is important to consider the meaning of the term "required." Clearly it does not refer to any statutory requirement, since GASB has no such authority and has clearly stated (paragraph 32.c.2, quoted previously) that contributions are determined by entities other than GASB. The term does seem to specify what would be required to satisfy GASB's conception of an "actuarially sound funding policy" (paragraph 2). GASB cannot require states or pension boards to establish such a funding policy, but it can and does set standards for reporting the "Schedule of Employer Contributions." These standards require the plan to disclose the actual contributions, the ARC and the ratio between the two. GASB 25 adds:

> The standard neither requires nor precludes disclosure of information concerning the reasons for differences between the ARC and contributions made. For example, for some plans, the differences may be due entirely to statutory contribution requirements that differ from the ARC, and the employer(s) may consistently pay the statutory requirements. Those plans may wish to disclose that information … (paragraph 130)

GASB's power over contributions, therefore, is at most hortatory, through the financial reporting standards. For example, it is sometimes argued that credit rating agencies frown upon entities that contribute below the ARC. However, that may well depend on the nature of the discrepancy and the explanation provided under paragraph 130, as discussed further below.

Finally, consider the specific Parameter on which the Transition Costs claim is based, the standard for calculating the amortization component of the ARC:

> Amortization method – The provision(s) for amortizing the total unfunded actuarial liability may be determined in level dollar amounts or as a level percentage of the projected payroll of active plan members. If the level percentage of projected payroll method is used, the assumed payroll growth rate should not include an assumed increase in the number of active plan members; however, projected decreases in that number should be included if no new members are permitted to enter the plan (for example, a plan that covers only employees hired before a certain date). (paragraph 36.f.3) [13]

There are several notable points to this standard. First, the level percentage method applies to payroll of "plan members" only; it does not include payroll of employees in any new plan. Second, although payroll generally grows with both the number of members and the average salary, it is only the latter that can be included in the assumed payroll growth rate. Lastly, and most important for this inquiry, if the DB plan is closed to new members, one must include projected decreases in the number of members in the payroll growth assumption or else switch to level dollar in calculating the ARC. In practice, it is usually assumed that closing the plan forces a switch to level dollar, since that is less of a change than shifting to a front-loaded schedule, as would be required under a negative payroll growth assumption.[14]

In summary, the first component of the Transition Costs claim is true: GASB 25/27 does require acceleration of the ARC's amortization schedule if the DB plan is closed to new members. The rule as stated is unambiguous. To complete the analysis one must next consider the other two components of the Transition Costs claim: (1) what exactly is the link, if any, between GASB's ARC and actual contributions, and (2) what is the policy rationale for the GASB 25/27 rule on amortization when the DB plan is closed?

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13) The same language appears in Statement 27, for employers, as paragraph 10.f.3. See GASB (1994b).

14) If the assumed salary growth rate exceeds the rate of decline in the number of members, the payroll growth may still be positive in a closed plan for a period of time. Ultimately, however, the number of members in a closed plan shrinks to zero, and so must the payroll.

3. Does GASB's ARC Determine Funding Policy?

As previously shown, GASB standards govern financial reporting and accounting but not funding policy. The actual funding requirement is determined by statute or, in some cases, by the pension board if the statute has delegated that decision. In rare cases, the statute or board policy may explicitly stipulate that contributions follow GASB ARC, but even then it is a policy choice, the wisdom of which will be discussed in the next section. On the specific question of whether that choice exists, or whether GASB ties states' hands on funding policy, there is considerable confusion, because of some inaccurate or misleading claims in pension reform debates. Consider first a few particularly bold statements of the Transition Costs claim. These can be contrasted with more careful statements of what GASB requires, to follow.

3a. Incorrect Claims that GASB's ARC Determines Funding Policy

NIRS (2008), in the brief mentioned earlier, summarizes the claim as follows: "*Accounting rules can require pension costs to accelerate in the wake of a freeze.*"[15] (p.1) The brief elaborates:

> According to GASB … payments can be made either in level dollar amounts or as a level percentage of the projected payroll of the active employees in the plan. In an open plan, payroll can be expected to continue to grow over time, as retiring employees are replaced by new hires, and average pay increases each year. As a result, payment schedules in open plans can see the dollar amount of payments gradually increase, at the same rate as the growth in payroll. But once a plan is frozen to new entrants, the number of active members in the plan will steadily fall, as individuals retire, meaning an ever-smaller payroll base over which to spread payments. Because of this, accounting rules require that if a plan is frozen to new entrants, either the unfunded liability must be paid in level dollar amounts, or as a level percent of a decreasing payroll. (p. 3)

The brief then observes that "accelerating pension payments is unlikely to be a helpful strategy for a state or local government looking for ways to manage through a difficult fiscal environment" (p. 4). The discussion of this point concludes by pointing to Alaska – a state that converted to DC in 2006 – as a cautionary example of "accounting rule-driven spikes in pension contributions" (p. 4).

The NIRS brief accurately states the nature of the GASB accounting rule, as shown above, but it misstates the rule's significance. As the passage shows, NIRS consistently states that GASB accounting rules dictate "payments" (i.e. funding policy), but this is false. GASB rules govern financial reporting only, not "payments" or funding policy. Indeed, the example of Alaska, considered later in this paper, proves this point, and disproves NIRS' claim.

The NIRS brief is one example, but it is significant because NIRS is the designated "research and education" arm of the public pension industry.[16] The brief is widely cited in states where pension reform is considered, often by its affiliated national pension organizations, which commonly testify in those states.

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15) The term "freeze" refers here to closing the DB plan when a DC plan is adopted.

16) The mission of NIRS is to provide "research and education" for policymakers on retirement systems. Located in Washington, D.C., NIRS has three categories of members from the public pension industry and associated entities. Its four "Leadership Members" are NASRA, the National Conference on Public Employee Retirement Systems (NCPERS), the National Council on Teacher Retirement (NCTR) and the Council of Institutional Investors (CII). Its 37 "Educational Sustainers" primarily include actuarial firms, asset management firms and unions (AFL-CIO, AFSCME, AFT and four state teachers' unions). Its 82 Associate/Charter Members are virtually all public retirement systems. The chair of NIRS' Board of Directors is the immediate past president of NASRA, and its other directors are current officials in NASRA, NCPERS (2), NCTR (2), CII, and three state retirement systems. See NIRS (2011) Annual Report 2011, retrieved from www.nirsonline.org/storage/nirs/documents/nirs_annualreport2011_web.pdf

Minnesota's three statewide retirement systems and their consulting actuary, Mercer, provide another example of this confusion in a legislatively directed study (Minnesota Statewide Retirement Systems, 2011). This report states:

> After a DB plan is closed to new hires [for either a pure DC or a hybrid plan], it is common practice for actuaries to calculate the future contributions required to amortize its unfunded liabilities based on a level dollar method rather than a level percent of pay method…(GASB, Statement 25, 36(f) and Statement 27, 10(f)). (pp. 63 and 76)

The passage's citation of GASB 25 and 27 implies that GASB drives the funding policy change. In so doing, Minnesota follows the NIRS brief that the report cites here (citation not shown above). In addition, the passage cites the Mercer analysis provided to the Minnesota systems for this report. Mercer's letter is attached to the report. The subject of the letter is "a comparison of projected contributions" under the current DB plan and a conversion to DC (the "DB/DC plan"). Mercer concludes that "The DB/DC plan clearly has higher annual contributions in the short-term [$1,502 million during years 1-5], as payments for the unfunded liabilities are accelerated." Mercer goes on to explain:

> Unfunded liabilities are amortized as a level dollar amount …The Government Accounting Standards Board (GASB) Statement No. 25 does not permit the current level percent of payroll amortization method, which assumes a constantly increasing payroll, to be used for a closed plan. (p. 87)

The reference here is clear: Mercer is stating that GASB drives funding policy. This is not true; GASB drives financial reporting and accounting. There is no ambiguity in Mercer's misstatement: the subject of the letter is actual contributions, and the letter nowhere mentions financial reporting and accounting, the true subject of the GASB Statements.

In these two examples, NIRS and Minnesota/Mercer err in claiming that GASB drives funding policy. There are also other explicit examples and cases where the claim is implied.[17] The fact that erroneous statements like these are influential is particularly striking since accurate statements of GASB's role are easily available.

3b. Explanations that GASB's ARC Does Not Determine Funding Policy

Unlike the claims of interest groups, such as NIRS, and a few actuaries, such as Mercer, the claims of many actuaries and their pension fund clients are more accurate, or at least more circumspect. For example, even though the Executive Summary of the CalPERS report previously cited incorrectly identifies "front-loaded [pension] expenses" as one of "the costs and risks of closing a DB plan" (referring to contributions), the body of the report is careful to state that this "accounting impact" is not necessarily a funding impact. As the report

17) In Michigan, the Senate Fiscal Agency has also erroneously stated that "If a DB system becomes closed to new employees, accounting rules require the unfunded liability to be paid off over 30 years as a level dollar amount." See Michigan Senate Fiscal Agency (2009). The case of Nevada falls in a slightly different category; it does not state that GASB drives funding, but rather that actuarial practice drives the acceleration. Specifically, the consulting actuary for the Public Employees' Retirement System of Nevada (2010), the Segal Group, concluded that closing that state's DB plan in favor of a DC plan would accelerate amortization payments, resulting in $1.2 billion of extra contributions for the two-year period FY12-13, a figure that featured prominently in that state's debate. However, GASB 25 was not invoked as the basis for this calculation; indeed the report correctly limits its citation of GASB 25 to the implications for financial reporting. With regard to the funding decision itself, the report refers simply to "actuarially determined contribution rates." (p. 6) That is correct, since that is the language of Nevada law. See Nev. Rev. Stat. § 286.450. Yet, it leaves a fair amount of latitude on the precise actuarial method, including the continuation of level percent of payroll.

explains, "actual employer required contributions are determined on a funding basis which may differ from the accounting basis prescribed by GASB" (CalPERS, 2011, p. 5). In the case of CalPERS, funding policy is set by the Board. The report elaborates in a footnote:

> The CalPERS Board would need to review its amortization policy for funding purposes to determine whether or not it should be consistent between accounting and funding. This Brief does not assume any changes to the Board's current amortization policy for *funding* purposes. If the Board were to adopt a funding policy similar to the change mandated by the accounting standards, actual contributions would change in a similar manner to the pension expense shown on the table, Impact on Pension Expense. [emphasis in the original] (p. 5)

In other words, CalPERS acknowledges that the $529 million increase in "pension expense" (an accounting term) would not raise employer contributions unless the Board adopted such a funding policy.[18]

The consulting actuary for the Kansas Public Employees Retirement System (KPERS), Cavanaugh Macdonald, provides a particularly clear statement of the case. It is found in Appendix D of the "Fiscal Impact Report" prepared by KPERS (2011) for the Legislature on closing the DB plan in favor of a DC alternative. Cavanaugh was specifically asked to address the question, "What GASB requirements apply and how do they impact KPERS funding?" It is worth quoting from the answer at length:

> GASB 25 provides guidance for the preparation of governmental pension plan financial statements. It contains procedures regarding the calculation of pension costs to be recognized in different time periods. *This is strictly related to accounting for pension benefits, and does not represent a requirement to fund the plan under the standard.* It does, however, provide one frame of reference with respect to the funding of the UAL. The key measurement in GASB 25 is the Annual Required Contribution (ARC). The Standard sets out rules regarding the amortization of the unfunded actuarial liability for the Annual Required Contribution (ARC). In general, the standard provides that the UAL may be amortized as a level dollar amount or as a level percent of payroll. However, it states that if the level percentage of payroll method is used, projected decreases in the payroll should be reflected if no new members are permitted to enter the plan. Therefore, *for GASB reporting purposes,* the ARC would have to be amortized as a level dollar amount or over a decreasing payroll stream, if the percent of payroll method is used. [emphases added] (p. 52)

Cavanaugh concludes its answer as follows:

> *It is important to note that the rules in place under GASB 25 apply to the accounting of pension benefits and are not required to be used to fund the plan.* Therefore, absent a requirement in state law or city ordinance, a retirement system does not have to contribute the amount of the ARC. However, the ARC must be calculated in accordance with GASB 25 and used in exhibits in the financial statements of the system and employer. To the extent the actual cash contributions are less than the amount determined under GASB 25, it is reflected and disclosed in the GASB 25 exhibits. *This is the same situation that has occurred with respect to the KPERS contribution for the last 16 years, i.e. the full ARC has not been contributed.* (p. 54)

18) A more recent statement by CalPERS seems less circumspect. Reacting to Governor Brown's proposed move to a Hybrid Plan, CalPERS stated on November 11, 2011, "[I]f the design of the Hybrid Plan results in the closing of the current DB plan there would be a significant cost impact to the employer due to changes in asset allocation and amortization methods." The reference to "amortization methods" appears to be the claim considered here, but the CalPERS statement refers to "cost impact to the employer" (i.e. contributions) not "pension expense," the accounting term previously used. See CalPERS (2011b).

Consequently, when Cavanaugh analyzes the costs of closing Kansas' DB plan and converting to DC, the amortization method is unchanged: level percent of payroll. This report helped inform the KPERS Study Commission, created by the Legislature in 2011 and charged with making recommendations to the Legislature about structural pension reform in 2012.[19],[20]

These two examples are not alone. Actuaries for other states are also careful to distinguish between a system's funding policy (set by statute) and financial reporting standards (set by GASB).[21] Nonetheless, confusion persists.

3c. A Claim that GASB's ARC Both Does and Does Not Determine Funding Policy

An excellent example of the confusion about GASB's role is provided by the consulting actuary for the Kentucky Retirement Systems (KRS) in his evaluation of Senate Bill 2 (SB 2) in 2011, a bill that proposed closing the state's DB plans to new members in favor of a new DC plan. The actuarial analysis claimed that GASB's ARC both determines and does not determine funding policy, depending on how repetitively the Legislature asserts in statute its policy prerogatives.

By way of background, KRS includes separate systems for different groups: Kentucky Employees Retirement System (KERS), State Police Retirement System (SPRS) and County Employees Retirement System (CERS). Kentucky statute is unusually specific in prescribing the amortization method. It specifies for each of these systems the "the level-percentage-of-payroll amortization method" (Ken. Rev. Stat. § 61.565(1)), a provision that began with the 2007 valuation. SB 2, proposed in 2011, would have closed all the DB systems and instituted DC for new employees, but the bill did not amend this provision. The effect of the proposal was to continue using level percent amortization.[22]

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19) Certain changes were enacted to the existing DB plan in 2011, but the changes were made contingent upon the KPERS Study Commission submitting its recommendations and having the Legislature vote on them in 2012. The Commission's report, submitted January 6, 2012, recommends adopting a Hybrid for new and non-vested employees, with a DC component and a Cash Balance component.

20) In addition to the Cavanaugh report, the KPERS Fiscal Impact Report also included a letter from the legal firm of Ice Miller, in Appendix E. The letter was primarily addressed to the Legislature's question of whether federal law required an acceleration of amortization for closed DB plans (Ice Miller's answer was "no"). In the course of the letter, Ice Miller also discussed GASB Statements 25 and 27. In so doing, Ice Miller (like Cavanaugh) stated, "It is important to realize that the GASB statements do not impose actual funding requirements; instead they impose standards for financial reporting on funding status and progress."

21) In describing the GASB 25 provision for closed plans, Florida's consulting actuary, Milliman, writes, "For purposes of developing the ARC for financial reporting purposes, GASB would require a different amortization technique [from the statutory method discussed in the previous sentence]." See Milliman (2011), p. 7

Similarly, in evaluating a proposed shift to DC in New Hampshire, that state's consulting actuary, GRS, writes, "For purposes of determining the ARC we believe the System will be required [by GASB] to use a level dollar method or a method that reflects the declining payroll of the closed active population of the System. To the extent future actual contributions (based on a level percent of pay amortization) are lower than the calculated ARC (based on a level dollar approach), the System will report contribution less than 100% of the ARC". See NHRS (2011), p. 6. Thus, GRS recognizes New Hampshire's statutory authority to continue level percent of pay amortization for "actual contributions," and GASB's authority to require level dollar amortization for financial reporting.

22) See Kentucky Legislature (2011). This applied directly to contributions by employers of members in the old DB plans and indirectly to employers of members in the new DC plan. The latter contribution was set equal to the former and included (after matching employee contributions to the DC plan and a few other items) a contribution to amortize the old plans' unfunded liability. The proposal codified a "total payroll" approach for amortization.

The consulting actuary for KRS – Cavanaugh – took a different stance. In its actuarial letter to KRS evaluating SB 2, Cavanaugh opined that GASB not only governs funding policy (as opposed to financial reporting), it even trumped statute. It is worth quoting the actuarial letter in full (KRS, 2011a):

> …*as contemplated by the Bill, the contribution necessary to amortize the unfunded accrued liability (UAL) of the various KRS funds will not change* but rather will continue in the future until the UAL is completely funded. In fact it is likely the UAL contributions will have to be calculated on a level dollar basis once the KRS funds are closed to new members *in order to meet the current GASB requirements for closed plans*. This will result in an increase in required contributions in the early years after the legislation becomes effective when compared with the results using level percent of pay UAL financing as is now being done. [emphases added] (p. 2)

The first sentence seems to recognize that the law calls for continuing the same amortization method for contributions, and the method is identified as level percent in the last sentence. The second sentence, however, asserts that GASB requirements govern contributions. The actuarial letter provides no explanation of why the explicit statutory requirement to amortize using level percent would be voided by SB 2, other than to invoke "GASB requirements for closed plans."

The Cavanaugh letter built level dollar payments into the cost projections for the bill. That is, the cost projections were based on violating the statute's pre-existing provision, ch. 61, § 565(1), which would still apply under the bill that was purportedly being evaluated. The significance of this was profound – it played a major role in ultimately defeating the bill.

Cavanaugh's cost projection, prepared for KRS, was provided to the Legislative Research Commission (LRC) to use in its fiscal impact statement. At the same time, headlines in the Louisville Courier-Journal, based on the report, proclaimed: "Pension reform bill: Pay now, save later." The article led with the claim that the bill would add almost $8 billion in taxpayer contributions during the next 15 years before it started saving any money (Wartman, 2011). The KRS Board voted 5-0 in opposition to the bill on the grounds of "the enormity of the financial burden that SB2 places on the employer agencies" (KRS, 2011c).

Of particular salience was the purported impact on county employers. Since local governments in Kentucky (as elsewhere) carry influence in the Legislature, the bill was amended to reduce contributions for CERS, the county system. In so doing, the amendment also reiterated that CERS contributions "shall continue to be determined under the level-percentage-of-payroll amortization method rather than the level-dollar amortization method…" (Kentucky Legislature (2011), proposed ch. 61, § 565(6)(c)1) In other words, under SB 2, the statute would have continued to require level percent amortization for all three systems under 61, § 565(1), and, as amended, SB 2 carried a repetition of this requirement (redundant as it may have been) for CERS in 61, § 565(6)(c)1.

Cavanaugh's cost projection for the revised bill changed the CERS calculation to level percent "due to the mandate in the bill" (KRS, 2011b, p. 2), but maintained level dollar for KERS and SPRS. Cavanaugh's revised letter offers this opinion among its concluding comments:

> For KERS and SPRS, passage of this legislation will likely require a shift from level percent of payroll financing of the UAL to level dollar financing in order to meet current GASB requirements. While not impacting the overall cost for employers such a change does generate a higher cost early in the amortization period and a lower cost later, as is evidenced by the

> projection results. *This change would also have been required for CERS had the Senate Committee Amendment not mandated the use of level percent of payroll financing for the CERS funds regardless of the GASB requirements.* [emphasis added] (p. 16)

In accepting the fact that CERS was mandated by the proposed statute to use level percent, GASB notwithstanding, Cavanaugh rightly accepted the primacy of statute for funding policy over GASB accounting rules. But for KERS and SPRS, Cavanaugh continued to opine that GASB trumped statute.

The Senate passed SB 2 (revised) on February 11, 2011, but it died in the House.

This is a cautionary example of the power of false pronouncements, when issued by trusted actuaries, embraced by interested parties in the pension system and local government, uncritically repeated by a legislative research unit and broadcast by misinformed media to nervous taxpayers. This story, repeated elsewhere, is one where a legislature defers without question to those believed to hold arcane knowledge by virtue of their mastery of actuarial calculations, even when they arrogate powers to GASB that GASB would never claim for itself. To be sure, this is not true of all or even most actuaries. As previously seen in the discussion of Kansas (KPERS, 2011), the same actuarial firm – Cavanaugh – very clearly stated, "It is important to note that the rules in place under GASB 25 apply to the accounting of pension benefits and are not required to be used to fund the plan." (p. 54)

4. Should GASB's Rule on the ARC for "Closed Plans" Determine Funding Policy?

Since funding policy is determined by statute, not GASB, states have choices. States can choose, as a matter of policy, to follow GASB accounting standards in determining actual contributions, and there are pension plans that do so, particularly when the pension board has the authority to set the rate. But many states do not.

In some states, contribution rates are simply flat percentages set in law, independent of the ARC, such as the 14 percent employer contribution rates by school districts in Arkansas and Ohio, rates that are rarely adjusted. In other states, such as Missouri, the statute slowly adjusts the district contribution toward the ARC at a controlled rate (no more than 0.5 percentage point per year). In Massachusetts, where the contribution to teachers' pensions occurs at the state level (rather than district), the funding schedule is set periodically by legislative negotiations, with an eye to the ARC, but tempered by all the normal legislative give-and-take, including sensitivity to the state of the business cycle.[23] In these examples, the ARC has served as a guidepost, but not a strict constraint on funding policy.

In other cases, such as Illinois and Pennsylvania, contributions fall so far short of the ARC – or of any other reasonable benchmark for fiscally sound contributions – that the GASB requirement to report that shortfall serves well to flag the irresponsible nature of the policy in these states.[24] This contributes to public shaming (e.g., in bond disclosure statements read by rating agencies) and may eventually help induce such states to adopt sound policies.

23) During the author's public service in Massachusetts, he participated at the staff level in this process.

24) In these states, funding policy has been codified in statute with makeshift formulas designed to defer payments.

Ultimately, it is the soundness of the overall funding policy that matters, not the letter of the accounting rules. Even in those states where the pension board or statute itself uses the ARC to set contributions, these policy decisions can always be revisited when considering pension reforms, if the GASB rule is impeding sound policy. To assess whether sound funding policy requires adherence to the GASB rule to accelerate amortization for closed plans, it is useful to consider GASB's own policy rationale for its rule on amortization methods.

4a. What is GASB's Rationale for Forcing a Switch to Level Dollar?

In general, as both critics and proponents of pension reform might agree, the optimal pace of amortization payments (or debt reduction more generally) weighs inter-generational equity (i.e. not kicking the can down the road) against current liquidity constraints (i.e. not accelerating payments during times of fiscal strain). The GASB rule for amortization methods is based on inter-generational equity, as will be seen. But since this rule would require accelerated payments (if applied to actual funding policy) when the DB plan is closed, the rule is invoked against pension reform, on the grounds of current liquidity constraints. If this reasoning were valid, it would pose a dilemma, effectively locking states into existing pension plans, no matter how beneficial structural reform may be in the long run. It is worth examining the GASB rationale more closely to evaluate this purported dilemma.

GASB Statements 25 and 27 (1994a, 1994b) are structured with the standards presented first and the rationale for the standards provided in "Appendix B: Basis for Conclusions." The relevant standard, previously cited (paragraph 36.f.3, Statement 25; paragraph 10.f.3, Statement 27), carries the key proviso to switch amortization methods when "no new members are permitted to enter the plan." But what is the "Basis" for this proviso? Neither Statement 25 nor Statement 27 refers to this proviso in their Appendix B.[25] Statement 27's Basis for the level percent method, however, clearly implies the rationale for the "closed group" proviso. Paragraph 124 of Statement 27 (GASB, 1994b), Appendix B is reproduced here in full:

> A large majority of governmental plans use the level percent method, combined, most typically, with the entry age actuarial cost method. The level percent method reflects traditional principles of sound funding which require a level contribution design – that is, a design whereby future citizens are not expected to contribute more than present citizens. That concept is sometimes referred to as intergenerational equity in the burden on taxpayers. The concept is implemented by establishing a contribution rate which, expressed as a percentage of *active member payroll*, is expected to remain level over time. The contribution rate includes normal cost and an amount, computed as a level percentage of projected covered payroll, that is designed to amortize an unfunded actuarial liability over a specific period of future years. Although inflation is likely to cause the absolute dollar amount of contributions to increase over time, contributions expressed in dollars adjusted for inflation (real dollars) are expected to be constant. Therefore, the burden on citizens does not increase relative to *the payroll on which pension contributions are based.* [emphases added]

25) The paragraph in Statement 25's Appendix B that refers to the choice between level dollar and level percent (paragraph 151, repeated as paragraph 123 in Statement 27) qualifies the ruling that either method is acceptable with the phrase "from the long-term, ongoing plan perspective." But no rationale for that qualifier is provided.

This shows that the GASB rule is intended to ensure intergenerational equity, interpreted by GASB to mean that contributions do not rise in real dollars.[26] To be sure, this is an uncommonly accommodating definition of intergenerational equity. Usually the concept would mean that each generation pays for its own benefits, rather than having future citizens pay anything for the employment services provided to current citizens. For the purposes of this paper, however, consider GASB's stated goal, to keep future citizens from contributing more than current ones.[27]

Level percent of "active member payroll" achieves that goal, whether payroll is rising or falling. In an open plan, with payroll rising, contributions rise, but not in real dollars (since assumed payroll growth is limited to salary inflation). If the plan is closed, so plan membership is projected to fall, that must be factored into assumed payroll growth, turning it negative. Thus, the amortization schedule shifts from a rising one to one that is falling, in both nominal and real dollars. The two schedules have the same present value, so the new schedule starts higher and ends lower. GASB's criterion for intergenerational equity is advanced by the shift, since future citizens will now contribute *less* than present citizens. The problem is with liquidity constraints, since the new schedule requires a sudden jump in contributions before eventually declining to lower levels. To mitigate this effect, the GASB rule allows closed plans to switch to level dollar, the only alternative considered by GASB to level percent of "active member payroll."

4b. GASB's Rationale Can and Should be Satisfied Using Level Percent of Total Payroll

The careful reader (helped by the emphases provided) will notice the slip between "*active member payroll*" and "*the payroll on which pension contributions are based,*" the phrase used in the closing of paragraph 124. The GASB rule implicitly assumes these two concepts are the same. But under several plans (discussed below) they are not the same, nor should they be. The unfunded liability is an obligation by the employer to fund benefits previously accrued, quite independently of whether new employees go into the old plan or a new plan. The obligation is unaffected by closing the old plan to new members, and the amortization payments also should be unaffected. This is accomplished by taking the percentage that was previously applied to the DB member payroll and, upon closing the old plan, extending it to total payroll. This will include both old DB members and new employees, but the total is the same. Consequently, the employer's amortization payments will be the same, as they should be, since nothing material has changed.

If level percent is applied to total payroll, instead of member payroll, GASB's stated rationale for level percent is still satisfied after the DB is closed. By taking the final phrase of paragraph 124, "*payroll on which pension contributions are based*"[28] and substituting it for the preceding term, "*active member payroll*," the paragraph

26) The concept of inflation embedded in the GASB standard is salary inflation. That is the assumed payroll growth rate (and, hence, projected contribution growth) since the assumed payroll growth may not include any projected increase in plan members. Note also that if plan membership does grow, contrary to the level percent method's assumption (while all other assumptions hold), the contribution rate will gradually decline as a percent of payroll, when the rate is recalibrated with each annual valuation. That is, the "level percent of payroll" method generates an amortization schedule that grows in dollar terms at the rate of salary inflation, but actually declines as a percent of payroll when plan membership is growing, because payroll is growing faster than the rate of salary inflation.

27) Left unspecified is whether the goal is to prevent contributions from rising in the aggregate or on a per citizen basis. But if one assumes that the taxpayer population is constant, the two are the same.

28) More precisely, one might replace 'pension contributions' with 'amortization payments' to exclude normal cost.

becomes consistent.[29] Level percent of *total* payroll (old and new plans alike) satisfies "intergenerational equity in the burden on taxpayers," defined by GASB as "a design whereby future citizens are not expected to contribute more than present citizens."

On policy grounds, the GASB rule to accelerate amortization for closed plans is flawed because it rests on a decrease in "active member payroll,"[30] rather than the payroll on which amortization payments are based. It is the latter that is relevant to intergenerational equity, as the final sentence of paragraph 124 clearly indicates. GASB does not seem to have anticipated that amortization payments might be levied on employers of those who are placed in a new plan, instead of the old one.[31] There is no reason to believe that *total* payroll (old and new combined) will follow any different trajectory than if the old plan had stayed open.[32] That is why the GASB 25/27 proviso to accelerate amortization for closed plans has no policy rationale if payments are based on *total* payroll, as indeed they should be.

This point is not new – it is well-known in the pension and actuarial community. For example, the Cavanaugh Macdonald report in Kansas (KPERS, 2011) states the following:

> If the UAL payment is calculated using the total payroll of members in both the DB and DC plans, the dollar amount of the payroll is the same as if the DB plan were still open. As a result, the UAL is amortized at approximately the same rate of pay as would occur if the DB plan had not been closed to new hires.(p. 50)

Of course, if a system adopts this funding policy upon closing the old DB plan, it will still be required, under the letter of the GASB rule, to report the ARC under level dollar and the discrepancy with actual contributions. Gabriel, Roeder and Smith (GRS) make this point in their valuation of proposed pension reforms in New Hampshire (NHRS, 2011):

> The proposal includes a provision for participating employers to continue funding the NHRS on the payroll for members of both the defined benefit and the defined contribution plan (i.e., an open group) …To the extent future actual contributions (based on a level percent of pay amortization) are lower than the calculated ARC (based on a level dollar approach), the System will report contribution less than 100% of the ARC. (p. 6)

As stated earlier, GASB 25 (1994a, paragraph 130) anticipates that plans may include in their financial report "information concerning the reasons for differences between the ARC and contributions made," and as discussed later, plans that have adopted this approach have done exactly that. Rating agencies and other readers of the GASB 25 disclosure should be able to readily understand that a funding policy based on total payroll and level percent can be quite sound, even if it does not equal GASB's ARC, simply because the ARC is not based on total payroll.

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29) The term "covered payroll" also might be replaced for clarity, since it is often used to refer to plan members. However, GASB's glossary defines the term as "compensation paid to active employees [not the same as 'plan members'] on which contributions to the pension plan are based" (GASB, 1994b, paragraph 39), so technically the term stands as is.

30) This rule carries more force in the case where the plan "closes" because the entity is going out of business. (For example, some county governments have closed down.) In this case, there will be no employees or employer, beyond a certain point, so the UAL would have to either be wound down or assumed by a successor entity.

31) See GASB (1994a) paragraph 29 which lists the various sources of contributions, but does not mention this possibility.

32) It might grow faster, if savings from the new retirement plan help prevent layoffs that might otherwise occur.

5. How Have States Reformed Pensions, GASB Notwithstanding?

There are some states that have enacted reform, GASB notwithstanding. A few of them are examined in this section to see how this argument has played out. As noted earlier, there are several ways in addition to DC to reform retirement benefits in a way that ties benefits more closely to contributions. Cash Balance and two types of Hybrid plans are equally, if not more compelling, alternatives.[33] One reason why they may be more attractive politically is that in some cases the GASB 25/27 proviso for closed plans does not apply to them at all, even for accounting purposes. But in any case, reform plans are often structured with amortization on total payroll, so the policy grounds for continuing the level percent method remains intact.

5a. Cash Balance Plans: Actuarial Valuations of Proposals in Three States

Cash Balance (CB) plans are DB plans that look like DC in some important respects: employer and employee contributions accumulate in individual retirement accounts (in notional or book-keeping form), along with accrued earnings. The earnings, however, are guaranteed by the employer (hence the DB nature of the plan), so the employee does not bear any downside market risk, unlike DC plans.[34] The investments under CB are pooled, just like traditional DB funds. Individual pension wealth accrues uniformly on the fund's books, based on the contribution rate and guaranteed return, unlike traditional DB plans that generate sharp spikes in pension wealth accrual at arbitrary points during one's career. At retirement, individuals can convert balances to an annuity that looks much like a traditional pension.[35]

A shift to CB does not require the old plan to be considered "closed." CB is simply a new DB formula for distributing benefits, no different in principle than a new tier added to a traditional DB plan. Under this interpretation, accepted by actuaries, the new members and their employers continue contributing to the existing fund as before. Funds can be commingled and the employer contribution includes amortization, over and above the amount credited to the individual's bookkeeping account, in the same way that a traditional DB plan charges employers amortization over and above normal cost. Hence, there is no change to the trajectory of covered payroll or the amortization schedule. The GASB proviso for closed plans does not apply to CB.

Unlike the other reforms considered below, there is no readily available example of a public employer switching from a traditional DB to CB, to illustrate the reasoning above. The only statewide public CB plan is in Nebraska (which covers its state employees, but not its teachers). However, the Nebraska CB plan, which dates to 2003, did not replace a traditional DB plan; it replaced a DC plan. Several states – Kansas, Maryland, Montana, Pennsylvania and Louisiana – have recently considered moving from traditional DB plans to a CB plan (Fehr, 2011). In at least three of these cases, the actuaries evaluating the proposals agreed with the reasoning above: they did not find the GASB provision for accelerated amortization to apply to their cost valuation.

33) See NCSL (2012a), for a complete list of state plans that have adopted DC, Cash Balance or Hybrid plans.

34) CB plans can be structured to share upside risk. This is typically done by setting a minimum guaranteed return, coupled with shared benefits between employer and employee if fund performance exceeds that minimum.

35) Such plans were commonly adopted in the private sector a decade or two ago, when traditional pensions based on final average salary were phased out; many companies instituted DC plans, but those who stayed in the DB world often converted to CB. CB plans have been uncommon in the public sector. Interestingly, the National Conference on Public Employee Retirement Systems (NCPERS), "the largest public pension trade association in the United States," recently proposed the adoption of CB plans. However, NCPERS confined its recommendation to private sector firms that do not already have a pension plan, stressing that their proposal "is not a replacement for existing pension plans in the public or private sector." See NCPERS (2011).

In Pennsylvania, the proposed CB plan for the School Employees' Retirement System (PSERS) was explicitly cast as a "new benefit tier." There was no impact on the schedule of amortization payments, as the projections by their consulting actuary (Buck) showed.[36] Under current law (Act 120 of 2010), the amortization method for funding is set at level percent of pay with a 24-year amortization period, starting in FY12,[37] and Buck evaluated the 2011 CB proposal using the same method.

This does not mean PSERS contributions would meet GASB ARC parameters under either current law or the proposed CB legislation. In recent years, employer contributions under Pennsylvania statute have fallen to 27 percent of the ARC (PSERS, 2012). Under current law, "collars" are imposed on increases in the contribution rate, such that payments will not rise rapidly enough to prevent further deterioration of this badly underfunded system (69.1 percent funded as of June 30, 2011) for at least another decade (PSERS, 2012).

The proposed conversion to CB would have reduced future normal costs – the projected accrual of new liabilities. Together with the unchanged amortization schedule, the reduction in normal costs meant that the proposal would have started reducing contributions immediately. This is significant, because seriously underfunded states like Pennsylvania need to cut costs, but are often stymied by the GASB argument that costs will rise in the short run. That did not happen in Pennsylvania. The CB proposal was not adopted, but the GASB argument was not an obstacle.

Maryland is another underfunded state (64.1 percent funded ratio as of June 30, 2011) that has considered a CB proposal. Here, too, amortization has been calculated using level percent.[38] The General Assembly's consulting actuary (Mercer) who evaluated the CB proposal for the "Fiscal and Policy Note" continued to amortize the unfunded liability using level percent (with payroll growth of 3.5 percent).[39]

Louisiana currently has a CB proposal on the table, by Governor Jindal. Here, too, the consulting actuary (Buck) found no reason to change the amortization method. With no Transition Costs from accelerated amortization, Buck projects lower state contributions, as well as reduced taxpayer risk because of the proposal's risk-sharing provisions (State of Louisiana, 2012).

In short, actuarial opinions on proposed conversions from traditional DB to CB have not found the GASB proviso for closed plans to affect the cost projections: amortization costs were not accelerated. As a result, the CB proposals reduce costs, both in the short run and the long run, because of the cut in normal costs proposed in those states.[40] Although these plans have not yet been adopted, the GASB argument on accelerated amortization has played no role in the deliberations.

36) See Pennsylvania Public Employee Retirement Commission (2011), Attachment: Actuarial cost estimate by Buck Consultants. Table: "Comparison of Projected Pension Contribution Rates and Funded Ratios As of June 20, 2010. Current Plan vs. Representative Boyd's Proposed Cash Balance Legislation." Under "Employer Unfunded Liability Rate," the columns headed "Act 120" and "Cash Balance" are identical.

37) See PSERS (2011) p. 105. For GASB 25 disclosure, amortization is level dollar for 30 years.

38) Similarly to Pennsylvania, actual contributions have fallen short of the GASB ARC because of Maryland's "corridor method." The contribution budgeted for FY13, based on the FY11 valuation, is about 72 percent of the GASB ARC. See Maryland State Retirement and Pension System (2011).

39) See Maryland Department of Legislative Services (2011). Mercer's letter states that the actuarial methods used to evaluate the conversion to CB were the same methods used in the most recent valuation for the state (by GRS) of the existing DB plan. Private communication with Mercer confirmed that this included the amortization method, which was level percent.

40) There is nothing inherent in the CB design that reduces normal costs – it is a policy choice. For CB plans, the normal cost is simply the contribution rate. In the current fiscal environment, policymakers choose to set CB employer contribution rates below the old plan's employer normal cost.

5b. Hybrid Combination Plans: The Case of Rhode Island

Hybrid Combination plans (also known as "stacked" hybrids or "DB-and-DC" plans) provide employees with a small traditional DB plan combined with a DC plan. Examples include the Federal Employees Retirement System and the recently adopted plan in Rhode Island (Laura and John Arnold Foundation, 2011). Rhode Island's example is instructive. This is another deeply underfunded state: the funded ratio as of FY10 was 48.4 percent for state employees and teachers. Employer contributions meet GASB ARC but were slated to jump from about 22 percent (already high) to more than 35 percent for FY13, based on the FY10 valuation.[41]

The Rhode Island Retirement Security Act of 2011 converted the DB system into a DC-and-DB hybrid. As the DC component was added to the plan, DB benefits were reduced for new hires, and future DB accruals of current members were also pared back. Previously, the DB multiplier – the percent of final salary added to the pension for each year of service – averaged more than 2 percent per year for employees who served 25 years or more. Under the new plan, the DB multiplier was cut to 1 percent per year. In addition, previously accrued benefits for current members were reduced by suspending post-retirement COLAs. This provision, along with a few others, reduced the UAL and corresponding amortization payments. Finally, payments were decelerated by lengthening the amortization period from 19 years (remaining on Rhode Island's closed amortization schedule) to 25. The net result of the measure will substantially reduce employer contributions overall in present value, with the reductions timed for the next 19 years, followed by 6 years of higher contributions, because of the re-amortization.

The point here is that the GASB proviso to accelerate amortization for a closed plan did not apply: Rhode Island did not switch to level dollar amortization. The state will continue to use level percent of payroll and the same payroll growth rate – 3.75 percent.[42] The GASB proviso was not triggered, despite the fact that Rhode Island's new statute, unlike many others, ties contributions specifically to GASB standards, at least for normal costs, and implicitly seems to do so more generally.[43] That is, although the DB plan is now quite a bit reduced from what it was before, the system's actuary (GRS) does not consider the old plan closed for purposes of triggering the GASB proviso. In this respect, Rhode Island's reasoning is no different from those non-hybrid states that simply pared back their DB plan for a new "tier," without concluding that closing previous tiers triggers the GASB proviso for closed plans.

It is worth noting that GRS advised Rhode Island against switching to pure DC, in part because of its determination that closing the DB plan outright would trigger substantial additional amortization payments over the next 5 years.[44] This would be the case to the extent that Rhode Island statute tied funding policy to GASB accounting rules, regardless of whether those rules were a rational guide to policy. The fact that the hybrid did not trigger the GASB proviso, despite dramatically reducing benefits from the DB plan, indicates the

41) The jump was primarily due to the Board reducing the discount rate from 8.25 percent to 7.50 percent in 2011.

42) See State of Rhode Island General Assembly (2011b) for the GRS letter of November 14, 2011, which states that the new plan is valued using "the actuarial assumptions and methods previously adopted by the Retirement Board" (p. 5). Specifically, the payroll growth rate assumption is unchanged, as seen by comparing the note to the table "Estimated FY2013 Employer Contributions" (p. 2), with the GRS valuation report under the old system. See Employee Retirement System of Rhode Island (2011) p. 34.

43) See State of Rhode Island General Assembly (2011a), §36-10-2.1(a) for the explicit use of GASB 27 for normal cost. §36-10-2.1(b), on amortization, does not specify the method, but GASB is cited elsewhere in statute for determining the funded ratio.

44) The same argument recently prevailed in Virginia, where the Legislature's Pension Reform Conference Committee agreed to move to a Hybrid Combination plan. As the Senate Finance Committee's "Pension Reform Conference Report Summary" explains, "A Defined Contribution plan is not possible with the existing large Unfunded Liability. The Hybrid Plan moves the Commonwealth as far in the DC direction as possible without triggering the accelerated payment of the Unfunded Liability." See Virginia Senate Finance Committee (2012).

arbitrary nature of the rule and how it can fail as a guide to sound policy. The Rhode Island hybrid cut the DB multiplier approximately in half, to 1 percent.[45] How low would the multiplier have to be cut to consider the old DB plan closed under GASB rules? There is apparently nothing in the GASB rule that would require one to consider the old plan closed, even if the DB multiplier in a DC-DB hybrid were cut to 0.001 percent – the functional equivalent of a pure DC plan.

Rhode Island may well have had sound policy reasons for eschewing the switch to a pure DC plan, but the GASB rule would not have been among them. As will be seen, other states have adopted plans that allow or compel members to choose pure DC, despite their determination that this might trigger the GASB proviso for financial reporting. In the view of these states, that was not a sufficient reason to preclude an otherwise reasonable funding policy since they could levy amortization payments on total payroll.

5c. Hybrid Choice Plans: The Case of Utah

Hybrid Choice plans (also known as "side-by-side" hybrids or "DB-or-DC" plans) provide employees with a choice between a DC plan and a DB plan. Such plans have been used for years (e.g., Ohio[46]). A particularly relevant recent example is the Utah Retirement Systems (URS), which enacted a new system in 2010, effective July 1, 2011. New hires enter Tier II, which offers a choice between a DC plan and a Hybrid Combination plan. Utah's new plan is a hybrid of a hybrid – "DC or DB-and-DC."

A key feature of both Tier II plans – the DC plan and the Hybrid Combination plan – is that employers "shall pay the corresponding Tier I system amortization rate of the employee's compensation … to be applied to the employer's corresponding Tier I system liability."[47] That is, the contribution is based on total payroll, not simply members of Tier I.

Does this system trigger the GASB provision to switch from level percent of payroll to level dollar, either in financial reporting or actual funding? The system's latest CAFR as of this writing covers the period ending December 31, 2010, so the system has not yet published the GASB 25 ARC under new law. However, the report makes it clear the funding policy will be unchanged and it will be with the approval of the system's actuary, Gabriel, Roeder and Smith (GRS). It is worth quoting at length from the GRS certification letter of August 16, 2010, in the 2010 CAFR (Utah Retirement Systems, 2011):

> The New Public Employees' Tier II Contributory Retirement Act (SB63) … will close the current retirement systems [Tier I] … to new members effective June 30, 2011. It creates a new retirement benefit structure (Tier II) for all employees hired after that date. Employers will continue to contribute the amortization rate to the current systems on the pay for Tier II members. Therefore, SB63 … creates a mechanism for ensuring that the UAAL is amortized over the payroll for both current [Tier I] and Tier II members…
>
> Under GASB 25, when a plan is closed to new members, the amortization charge should be determined based on the closed group's pay or as fixed dollar payments, rather than as payments which are level as a percentage of increasing payroll. However, because the plan will

45) In Virginia, too, the proposed Hybrid reduced the multiplier of the DB component to 1 percent. Still, the Senate Finance Committee concluded that retaining even such a small DB component "allows continued amortization of the current Unfunded Liability." See Virginia Senate Finance Committee (2012).

46) Ohio teachers and state employees choose between DB and DC plans; either way, the employer pays 14 percent, but only 10 percent goes into the employee's DC account, and the remainder helps amortize the DB plan's UAL.

47) See State of Utah (2010), §49-22-301(2)(c) and §49-22-401(2)(c).

> continue to receive amortization payments from the employers of Tier II members, i.e. based on the payroll for an open group of current and future employees, not the closed group of current members, we believe it is appropriate to continue to use a level-payroll amortization of the UAAL. (p. 119)

This means that although the old plan may be considered "closed," triggering the switch to level dollar amortization under GASB 25 reporting requirements, GRS believes it is appropriate to continue using level percent amortization for the actual funding schedule. Indeed, an earlier letter by GRS used even stronger language: "We would recommend against changing the amortization approach, since the amortization contributions are still being paid on the payroll of an open and increasing group (all Tier I and Tier II members)." [48]

GRS' approval is important, since the new statute (SB63) defines the amortization rate for funding as "the board certified percent of salary required to amortize the unfunded actuarial accrued liability in accordance with policies established by the board upon the advice of actuary."[49] The certification letter shows that URS has received in advance the approval of its actuary "to continue to use a level-payroll amortization" in its funding policy. It appears that URS' GASB 25 disclosure in coming financial reports may be level dollar, but the actual contribution rate will be level percent. The current assumed payroll growth used for the amortization calculation is 4 percent, and it seems unlikely that will change.

In short, the provision that the new plans include an employer contribution to the amortization of the old plan has led Utah to conclude, upon GRS' recommendation, that continuing level percent amortization is sound funding policy, notwithstanding GASB 25/27's proviso for level dollar financial reporting. Because GRS is a widely used actuary, this interpretation of what is "appropriate" may be applied in other states.

5d. Defined Contribution Plans: The Case of Alaska

The "total payroll" approach used for determining Utah's amortization does not rest on the fact that the new plan is a hybrid. The same logic holds when the new plan is pure DC. Here, too, employer contributions to the amortization of previously accrued liabilities can be imposed independently of whether the employee is in the old or new plan.

Sometimes there is confusion on this point, because the other DC contributions no longer go to the DB fund, and this is incorrectly seen as adversely impacting amortization. Specifically, the employee's contribution goes to his or her individual DC account instead of the DB fund. However, employees' DB contributions typically would not include anything for amortization – the contribution goes toward normal cost, to fund the currently accruing benefits of the employee.[50] The DC employer's matching contribution also goes to the DC account rather than the DB fund. But this match, too, is the counterpart of the employer's portion of the normal

48) See Utah Retirement Systems (2010), p. 6. The letter goes on to state that for reporting purposes, "the State and other employers might have to report a shortfall between the actual contribution paid and the GASB ARC [calculated under level dollar]." For an earlier discussion by GRS of the GASB requirement for Utah's proposed reforms, see Utah State Legislature (2009), pp. 4-6.

49) See State of Utah (2010), §49-11-102(7).

50) It might be argued that this accounting practice, crediting employees' DB contributions first to normal cost, is only a convention, and that all contributions are fungible. However, there is logic to this convention, because employees have the option, upon separation, of cashing out their contributions in lieu of retaining the right to a pension. Since departing employees can choose between their accumulated contributions and their accrued pension benefits, it is logical to view their contributions as excluding payments for benefits accrued by previous cohorts. If, however, employee contributions exceed normal costs (as for Illinois' new tier II hires), then the excess applies to amortization.

cost under the old DB plan.[51] So neither the diversion of the employee's contribution nor that of the employer's share of normal cost from the old DB plan to the new DC accounts represents any diversion of amortization payments.

The significant feature here is that DC employers will also pay toward amortization of the DB plan's UAL. This is rational, as the UAL remains the responsibility of the employer for benefits owed to its previous employees, regardless of what plan its new employees enter.

Consider the case of Alaska, which enacted a pure DC plan in 2005, effective for all new hires after July 1, 2006. As previously noted, Alaska was depicted by NIRS as the poster child for the adverse impact because of GASB. Here is the NIRS (2008) account:

> Accounting rule-driven spikes in pension contributions can be significant, as the State of Alaska found out when it froze participation in its DB plans in 2005. The freeze forced additional contributions to the Teachers Retirement System [ATRS] to the tune of 14% of payroll, and required contributions to the Public Employees Retirement System [PERS] totaled an additional 9% of pay. These amounts were on top of the required contributions that were otherwise required. (p. 4)

The NIRS account, however, is incomplete.

First, by way of background, Alaska had not contributed the GASB ARC in the years immediately preceding the switch. For ATRS (the system considered here), contributions as a percent of the ARC in the last three years were 45 percent, 54 percent and 62 percent. This shows that Alaska's funding policy was not "accounting rule-driven" in the run-up to the switch.

ATRS did adopt level dollar funding for the first year of contributions governed by the new plan, FY08. This resulted in a contribution rate of 54.03 percent, rather than 42.26 percent, as would have been paid under level percent.[52] (Either one included an enormous – and overdue – acceleration of amortization payments from FY07, when less than half the calculated amortization was actually paid.)

In choosing the amortization method, the newly created Alaska Retirement Management Board was not constrained by statute to follow GASB rules, unlike Rhode Island. The statute merely required the Board to set "an appropriate contribution rate for liquidating any past service liability [i.e. UAL]" (Ak. Stat. § 37.10.220(a)(8)(B)). The Board set the rate for the first year under the new plan at its September 2006 meeting. The Board's consulting actuaries, from Buck and GRS, recommended level dollar, because the DB group was being closed. However, a move to total payroll amortization was already in the works. Minutes from the September meeting (ARMB, 2006a) indicate the thinking:

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51) The DC option under Indiana's new plan, established in 2011, illustrates this point well. New state employees choose between a DC plan and a DC-and-DB hybrid (which has been in place for decades). For an employee who chooses the new DC plan, the employer's total contribution is equal to the contribution rate for the old hybrid. Of that total, the employer's contribution to the DC employee's individual account is no greater than the normal cost that would otherwise be contributed to the hybrid. The remainder, applied to the DB plan's unfunded liability, is therefore no less than would otherwise be paid for amortization. See NCSL (2012a).

52) The impact was 12 percent, not 14 percent as reported in the NIRS brief. Similarly, the impact of level dollar amortization on contributions to the state employees' fund (PERS) was 7 percent (from 32.51 percent to 39.76 percent), not 9 percent as NIRS reports. The higher figures reported by NIRS, drawn from Board minutes of October 2006, were discussed in the context of some other changes that were not incorporated into the FY08 contributions. The FY08 contribution rates were set in the September 2006 meeting, and these were also reported in the October 2006 meeting. These are the figures published in the CAFRs of the two funds, which are dispositive. The contribution rates reported in this paragraph cover both pension and retiree health insurance; the valuation report that determined the FY08 contribution did not report these components separately.

MR. PIHL [board member] understood that there is no increase in the payroll base against which the dollars can be amortized.

MR. SLISHINSKY [consulting actuary from Buck] replied that this is correct because this is a closed group, so there is not an increased salary base. The calculation then focuses on a level dollar amount amortization payment irrespective of salaries.

MR. PIHL felt this did not reflect reality.

…

MR. PIHL noted that the payroll base upon which contribution rates are based will include both the DB and DC payroll.

MR. SLISHINSKY indicated this is not the case; the DB is a closed group and all new hires will be participating in the DC plan.

…

COMMISSIONER NORDSTRAND thought perhaps the Legislature intended to include the total PERS employer payroll as a basis for calculating the contribution rate for the DB plan, but the legislation only included the payroll for the DB legacy plan. One of the proposed fixes to SB141 included making this change.(p. 7)

As Commissioner Nordstrand indicated, the statute in effect at that time implied the employer's contribution rate applied to the payroll of DB members alone (perhaps unintentionally, as discussed further below) rather than the system's total payroll (Senate Bill 141 of 2005, § 10 (amending Ak. Stat. § 14.25.070)). As a result, the Board voted to set the FY08 contribution rates using level dollar.

At the Board's next meeting, in October 2006, further discussion of this issue ensued (ARMB, 2006b).[53] At the beginning of the meeting, the "Director's Update" included the following report:

TRACI CARPENTER, Director, Division of Retirement and Benefits stated the new DC plan is underway. Legislation is being prepared to meet the needs of the new plans. Among these are … changing the employer contribution rate to allow application of the past service rate to employer's entire payroll base, regardless of tier. These items will be included in the draft legislation proposed to the Governor-elect. (p. 16)

Later in the meeting, William Fornia, the consulting actuary from GRS, reported on his evaluation of Buck's earlier recommendations.[54] Perhaps unaware of the Board's intent to move to total payroll, Mr. Fornia repeatedly stated his strong support for level dollar. He explained:

MR. FORNIA…Level dollar amount is required if there is not an increasing payroll, which is the case with a closed plan. When a plan is ongoing, it is reasonable policy to continue to pay off unfunded liability over the future. When a plan is closed, there is less of a future. (p. 39)

53) Although this is the board meeting cited by NIRS, their brief does not refer to this section of the minutes, which reports on the Board's intent to move to total payroll, for the purpose of restoring level percent amortization.

54) Mr. Fornia, who now heads his own company, Pension Trustee Advisors, co-authored a widely circulated NIRS critique of DC plans. NIRS (2008). *A Better Bang for the Buck - the Economic Efficiencies of Defined Benefit Plans.* Washington, DC: Almeida, B., Fornia, W.

A few minutes later, however, the systems' consulting actuary from Buck acknowledged the move that was afoot:

> MR. SLISHINSKY…noted that there could be a statutory change to amortize over total payroll. There are questions as to whether or not that would be used for purposes of disclosure under GASB. But if the statute requires it be calculated that way, leaving in the payroll growth assumption would mean the cost starts out lower, but it increases over time. (p. 49)

The "fix" (to use Commissioner Nordstrand's term) was enacted as part of Senate Bill 123 of 2007. The change in language was instructive. In the original bill, the drafters took care to distinguish the term "plan" from "system" in the definitions section: " 'system' means all retirement plans established under the teachers' retirement system" (Senate Bill 141 of 2005, § 1 (amending Ak. Stat. §14.25.008(2)). However, in the section specifying the payroll on which the contribution rate would be calculated (§ 14.25.070), the drafters neglected to apply this distinction to the term "members." As a result, the payroll base under the original bill was that of the DB members only. The new bill amended this section, so the term "members" became "members in the system" (Senate Bill 123 of 2007, § 2 (amending Ak. Stat. § 14.25.070(a)). With this amendment, ATRS adopted the total payroll approach and reverted to level percent amortization after just one year, in FY09.

In the meantime, another statutory change was adopted to deal with the fact that employer contributions were set to skyrocket under either method – level percent or level dollar. Senate Bill 125 of 2008 set the local school district's contribution to 12.56 percent or the employer normal cost rate, whichever is higher. The employer normal cost rate for FY08 was 12.56 percent,[55] and that rate is now fixed in statute as the minimum local contribution. The amortization payments, which are much higher, have been paid by the state since then.[56] The amortization method, however, is unchanged – level percent has been used since FY09. The assumed payroll growth rate was set to zero for FY08 to yield level dollar amortization, but it has ranged from 3.62 percent to 4.00 percent since then.

To summarize, when Alaska closed its DB plan in favor of DC, the system switched its amortization method for one year to level dollar. Statute was immediately amended to set total payroll as the amortization base so the system could return to level percent amortization. The GASB 25/27 proviso for closed plans did not prove to be an obstacle for Alaska's reform. Alaska recognizes that GASB 25 governs financial reporting, and its GASB 25 disclosures report the ARC using level dollar. However, as Mr. Slishinsky, the system's consulting actuary from Buck, stated at the October 2006 Board meeting, in the very first months of the new plan, payments are determined by statute, not GASB. Buck's initial recommendation was to adopt level dollar, since amortization payments were applied to the closed DB group only. The extension to total payroll has allowed Alaska to return to level percent. Today, Mr. Slishinsky annually certifies the valuation report for ATRS (ATRS, 2011) with the following comment on the funding policy:

> The funding objective of the plan, as adopted by the ARM Board, is to set a contribution rate that will pay the normal cost and amortize the initial unfunded actuarial liability and each subsequent annual change in the unfunded actuarial accrued liability over a closed 25-year period as a level percentage of payroll. The funding objective for the plan, as adopted by the ARM Board, is currently being met. (p. 3)

There appears to be no current actuarial objection to level percent amortization.

55) This represented 3.96 percent for pension (net of employee contributions) and 8.60 percent for retiree health insurance.

56) To be more precise, if the employer normal cost rate falls below the employer's minimum contribution of 12.56 percent, the difference is applied to amortization, so the state's portion of amortization is correspondingly reduced.

Conclusion: GASB Rule Slated to be Eliminated; Funding and Reform are Policy Choices

This paper has examined the claim that GASB accounting rules impose Transition Costs on systems that close their DB plans, by requiring an acceleration of payments to defray the UAL. It is a jarring claim, on its face. It suggests that once a DB plan is enacted, it is virtually impossible to ever undertake fundamental reform.

Moreover, if this claim is correct, the plans that have been run most irresponsibly, running up the largest UAL, are those for which reform is singularly blocked. As a headline last year in the state of Virginia put it (reporting the conclusion from a legislative study group): "Retirement System Too Far in Debt for Reform" (McMorris, 2011).[57]

The claim, however, has no merit. GASB accounting rules govern financial reporting, not funding. As it happens, the GASB rule in question is slated to be eliminated, as part of GASB's larger process of revising Statements 25 and 27, established in 1994. GASB issued its "Preliminary Views" in June 2010, and issued the "Exposure Draft" in June 2011 of what the new standards will likely be. The impact on this issue is quite dramatic: *<u>GASB's intention is to drop the ARC construct altogether.</u>*[58] The Exposure Draft (GASB, 2011) is quite explicit:

> …this Statement does not establish an ARC, or similar measure. As a result, the Board does not believe that it would be appropriate to require disclosures about a standardized measure of the amount an employer would need to contribute to a pension plan each year as part of a systematic contribution plan in order to reach projected objectives. (paragraph 257)

The Exposure Draft is clear about the reason GASB is dropping the ARC. It is precisely because others have misconstrued GASB "as having established de facto contribution policy standards," despite the fact that GASB objectives are completely separate from "public policy matters such as pension contribution policy" (paragraph 257). GASB never wanted to be in the funding policy business to begin with and has now concluded that the best way to prevent it from being put in that position is to drop the ARC.[59]

Many observers would acknowledge that the de facto standard (as some view it) represented by the ARC has generally served as a reasonable benchmark for fiscally responsible contributions, when broadly understood: states that fall far short of the ARC are typically failing to properly fund their pension plans. When examined closely, however, not every ARC rule is compelling. The rule for accelerated amortization of closed DB plans has certainly proven to be counterproductive. Although intended to advance fiscally responsible funding, the rule has instead been used to impede fiscally responsible reforms.

57) In 1996, when Michigan moved new state employees to DC, but not its teachers, a determining factor was reportedly that the teachers' fund had a large UAL, but the state employees' fund did not. See Mackinac Center for Public Policy (2012).

58) This has been recognized by actuaries commenting on proposed pension reforms. For example, GRS' evaluation for New Hampshire states, "if the proposed changes in the Exposure Draft for GASB 25/27 are formally adopted by GASB (currently expected by FY2014), the calculation of the ARC will be eliminated but the issue remains." See New Hampshire Retirement System (2011), p. 6.

59) If the employer's funding policy is specified actuarially, GASB will still require financial reports to disclose a 10-year history, comparing actual contributions with the policy's "actuarially calculated contribution." But the latter is not a GASB-specified ARC – it is the employer's funding policy. GASB will set no "Parameters" for how the employer should determine its contribution, or, indeed, if it should be actuarially determined at all. As the draft states, "For employers that do not have a funding policy based on actuarially determined amounts, that fact would be evident through the required description of the employer's funding policy and the absence of actuarially determined contribution information in the employer's financial report." See GASB (2011, paragraph 259).

GASB is expected to issue its new Statements this year. If the ARC is in fact dropped, this should put an end to the false claim that GASB poses an obstacle to pension reform. The issue then returns to where it belongs: the responsible public bodies in the policy arena.

The issue of pension reform concerns the structure of future retirement benefits. This is entirely distinct from the funding schedule for amortizing the UAL – a financial policy decision on past obligations. The amortization decision is not altogether different from a state's decision on scheduling payments on ordinary debt. States have generally proven capable of responsibly scheduling debt service, sometimes with the guidance of the rating agencies. As GASB cedes the corresponding role it involuntarily played in pension funding policy, the states will be obliged to take responsibility for sound amortization scheduling, as they do for other forms of debt.

Pension reform is a separate issue from amortization. These two issues have been conflated by those invoking the GASB proviso for closed DB plans, but this has only sown confusion. This is clearly demonstrated when the reform is structured with amortization payments on total payroll. In this way, the growth in the base for amortization payments is unaffected by the reform, so there is no policy reason for changing the schedule of these payments. If that schedule were previously considered prudent, then it should be continued; if it were previously considered imprudent, then it should be accelerated anyway, with or without pension reform. The funding schedule for amortization is a red herring, irrelevant to the fundamental policy decision for pension reform. Amortization pays for past debts; pension reform lays a path toward a responsible future.

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