

What happened to the pension liability of Connecticut State?

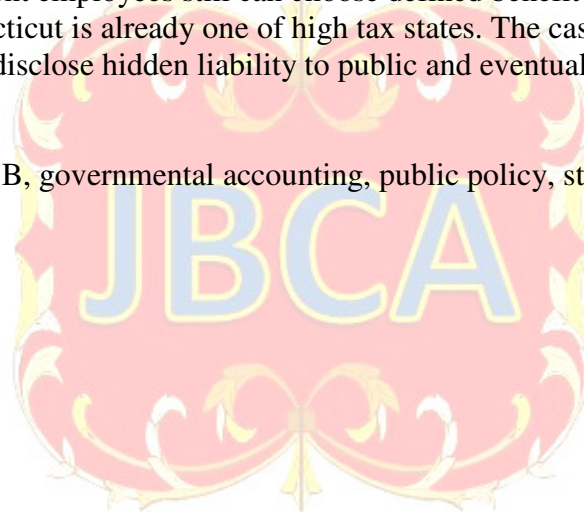
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Abstract

Implementation of Governmental Accounting Standards Board Statements No. 68 had increased pension liability for state and local governments significantly. However, this had hit State Government of Connecticut harder than others due to several reasons. First, net position of the government was negative even before implementation. Second, the state has used very optimistic assumption (high discount rate) to calculate net present value of future pension liability. Third, government employees still can choose defined benefit pension plan as of April 23, 2019. Finally, Connecticut is already one of high tax states. The case illustrates how an accounting standard can disclose hidden liability to public and eventually change a state government's actions.

Keywords: pension, GASB, governmental accounting, public policy, state government



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Introduction

The American Legislative Exchange Council (ALEX) pointed out that “unfunded public pension liabilities exceed \$5.9 trillion”, according to its annual study, unaccountable and unaffordable (2018). Among 50 states, in 2018, Connecticut’s total funding ratio was the lowest: 20.28%, which means that Connecticut’s pension funding has only 20.28% of money to fulfill the obligation for state employees and teachers, which could stimulate the attention of financial decision makers (See Exhibit 1).

Implementation of Governmental Accounting Standards Board (GASB) Statements No. 68 had increased pension liability for state and local governments significantly. However, this had hit State Government of Connecticut harder than others due to several reasons. First, net position of the governmental part was negative 12 billion dollars even before implementation. Second, the state has used very optimistic assumption (high discount rate) to calculate net present value (NPV) of future pension liability. Third, government employees still can choose defined benefit pension plan as of April 23, 2019. Finally, Connecticut is already one of high tax states.

What is GASB Statement No. 68?

GASB Statement No. 68, Accounting and Financial Reporting for Pensions, provides new financial reporting standards for state and local governments that offer pension benefits to their employees, replacing GASB Statement No. 27, Accounting for Pensions by State and Local Governmental Employers and GASB Statement No. 50, Pension Disclosures. Statement No. 68 addresses how to measure and recognize pension liabilities, expense, and expenditures and requires governments to provide supplementary information for past 10 years.

Implementation of Statement No. 68 has caused most governments to report considerably increased pension liability in their Comprehensive Annual Financial Report. For example, GASB Statement No. 68 dated in June 2012 (File No. 327-C) stated:

“This Statement requires the liability of employers and nonemployer contributing entities to employees for defined benefit pensions (net pension liability) to be measured as the portion of the present value of projected benefits payments to be provided through the pension plan to current active and inactive employees that is attributed to those employees’ past periods of service (total pension liability), less the amount of the pension plan’s fiduciary net position.” Accordingly, under GASB Statement No. 68, local and state governments are required to recognize a new measure of long-term liability (net pension liability) in their balance sheets, which was previously recorded only in the footnotes of their financial statements. Local and state governments need to prepare financial reporting with Statement No. 68 for the fiscal year ending on June 30, 2015 or later. As a result, pension liability has become a hot issue for many states from year 2016.

Implementation: The Connecticut State Government Case

To understand the impact of GASB No. 68, it can be helpful to pay close attention to the financial status of Connecticut State Government. In its comprehensive annual financial report for 2018, the net position (which is equivalent to stockholders’ equity for corporations) of Connecticut State Government was a whopping negative 12 billion dollars in 2014 even before

the implementation of GASB No. 68, and worsened to negative 35 billion dollars in 2015 after the implementation (See Exhibit 2). As an explanation on this deficit increase, state of Connecticut's comprehensive annual financial report for 2018 states:

“The significant increases in the deficit starting with the fiscal year ended June 30, 2008 ...

The most recent significant increases were the result of the implementation of Government Accounting Standards Board Statement No. 68 in the 2014-2015 fiscal year and ... , which required employers to post to their Statement of Net Position, their net liabilities for pensions and other postemployment benefits (retiree health care costs), respectively.”

In contrast, net positions of New York State were positive 27 and 33 billion dollars in 2014 and 2015, respectively, according to Comprehensive annual financial reports of New York State.

Taken together, it is worth noting that financial situation of Connecticut State Government has become bad to worse after adopting GASB No. 68.

NPV is computed by summing up all the future cash flow after time discount. Therefore, when higher discount is applied, NPV of future cash flow becomes smaller. In the context of pension liability, a state government can underestimate NPV of pension liability by assuming high discount rate.

Connecticut State Government had used 8 percent discount rate for State Employees' Retirement Fund and Judges' Retirement Fund, implying that the government had underestimated its NPV of pension liability, until 2016 and then reduced it to 6.9 percent. However, Teachers' Retirement Fund in Connecticut still applies 8 percent discount rate even in fiscal year 2018.

When the state government changed discount rate from 8 percent to 6.9 percent for State Employees' Retirement Fund in 2016, pension liability had increased by 6.5 billion dollars. If the state government adopts 6.9 percent discount rate for Teachers' Retirement Fund as well, pension liability will increase substantially¹. Also, if the state government makes more conservative assumption with lower discount rate, pension liability will increase significantly. For example, if 4 percent discount rate is applied, pension liability will increase by more than 10 billion dollars.

Defined Benefit Pension Plan

Under defined benefit pension plan, pension benefits are typically determined by “multiplying an employee's years of service by a formula multiplier (which typically ranges between one and two percent), then multiplying the product by the employee's final average salary (FAS) over a certain period.”, according to Hansen (2017).

Since retirees live longer and interest rate stays lower than decades ago, defined benefit pension plan usually generates heavier burden on pension funds than defined contribution pension plan. Until 2017, state employees in Connecticut could choose defined benefit plan. From 2017, every new employee should choose hybrid pension plan which is combination of defined benefit plan and defines contribution plan.

But there are two issues in this hybrid pension plan. First, new plan is mostly defined benefit plan. Multiplier of old defined benefit plan was 1.4 percent but that of new plan is 1.3 percent. Second, existing state employees still keep old defined benefit pension plan. Making

¹ Currently, Connecticut State Government has three pension funds such as State Employees' Retirement Fund, Teachers' Retirement Fund and State Judges' Retirement Fund. Net pension liability (total pension liability – plan net position) in fiscal year 2017 for State Employees' Retirement Fund, Teachers' Retirement Fund and State Judges' Retirement Fund are 21.1, 13.5 and 0.2 billion dollars, respectively. They are all underfunded as of fiscal year 2017.

new pension plan is better than no action, but this change will not save enough money for Connecticut State Government.

Challenges to State Taxpayers

After adopting GASB No. 68 in 2015, Connecticut's bond ratings were downgraded in the following years. In 2016, both Fitch and S&P Global lowered Connecticut's bond rating to AA- from AA. Connecticut's bond rating was further downgraded to A+ from AA- in 2017. Also, its bond rating was downgraded by Moody's to A1 from Aa3 (See Exhibit 3). These made Connecticut State Government harder to get debt financing.

In order to fill up financial loophole, Connecticut State Government has considered several ways to collect more taxes including sales tax increase, new sales tax on service, highway toll and sin tax on soda drinks. But Connecticut is already a high tax state. Tax Foundation ranks Connecticut as second out of 50 states in tax burden after New York State. Therefore, although the state government tries to increase tax revenue and reduce spending, it will not be able to save enough for underfunded pension trust funds in the near future. Connecticut State Government has underfunded its employees' pension funds for last decades. Implementation of GASB No. 68 made the devastated financial condition of the state government more visible to the public, and enforced the state government to recognize and repair underfunded pension trusts. However, pension funds of Connecticut State Government will remain seriously underfunded for next decades because of reasons addressed so far.

Discussion Questions

Q1. Defined benefit pension plan has resulted in a bigger burden on state governments than defined contribution pension plan. Why is that?

Q2. After the state government of Connecticut changed discount rate from 8 percent to 6.9 percent for State Employees' Retirement Fund in 2016, pension liability had increased by 6.5 billion dollars. Why is that?

Q3. Pension liability of Connecticut State stayed hidden partially because governmental accounting uses cash basis of accounting in many cases. What are advantages and disadvantages of cash basis of accounting?

Q4. Unlike state governments, the companies with 401(k) plan do not have pension liability issues. Why is that?

Q5. In years 2016 and 2017, Connecticut's bond ratings were downgraded. Could this affect financing decisions by the Connecticut state government? Why?

Q6. What would you suggest to do to mitigate the state government's pension problem?

References

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Resources

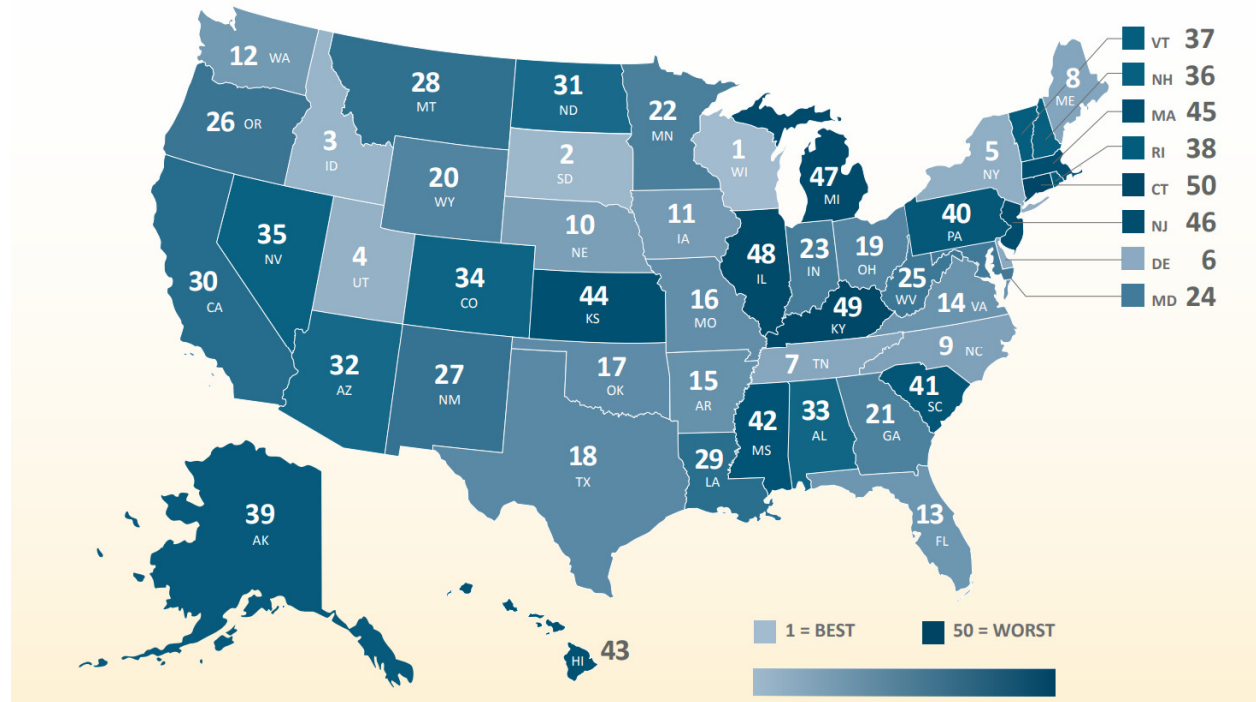
Comprehensive annual financial reports of Connecticut State are available at <https://www.osc.ct.gov/reports/index.html>

Comprehensive annual financial reports of New York State are available at <https://www.osc.state.ny.us/finance/>



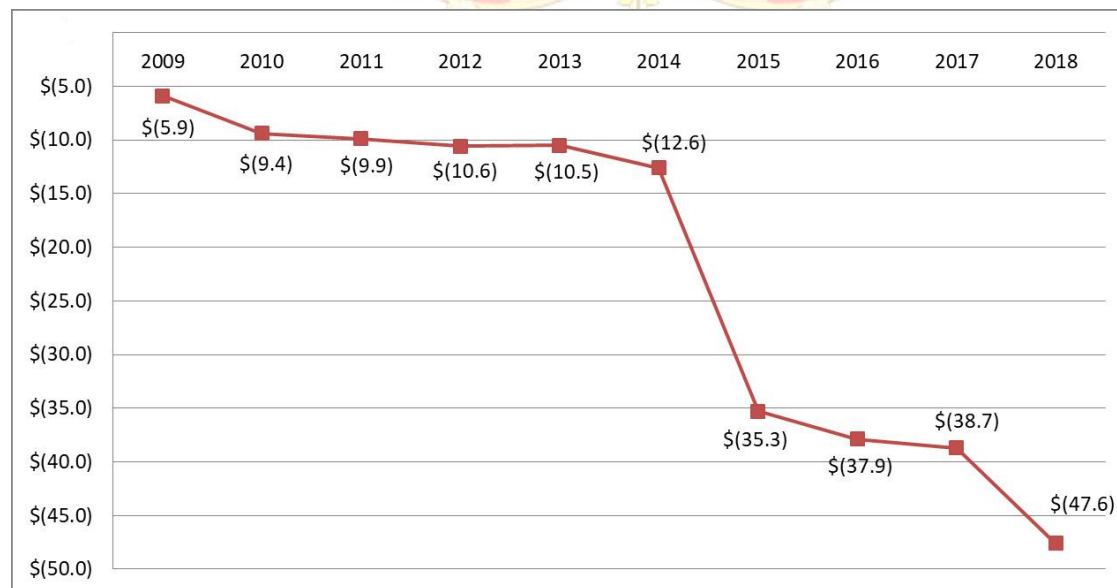
Appendix

Exhibit 1 Funding Ratio by State



Source: American Legislative Exchange Council. (2018). Unaccountable and Unaffordable.

Exhibit 2 Connecticut State Government Net Position



Source: Office of the State Comptroller (<https://www.osc.ct.gov/reports/index.html>).

Exhibit 3**Long-term Debt Ratings**

| Fitch | S&P Global | Moody's | |
|-------|------------|---------|-----------------------------|
| AAA | AAA | Aaa | Investment Grade |
| AA+ | AA+ | Aa1 | |
| AA | AA | Aa2 | |
| AA- | AA- | Aa3 | |
| A+ | A+ | A1 | |
| A | A | A2 | |
| A- | A- | A3 | |
| BBB+ | BBB+ | Baa1 | |
| BBB | BBB | Baa2 | |
| BBB- | BBB- | Baa3 | |
| BB+ | BB+ | Ba1 | Non- Investment Grade |
| BB | BB | Ba2 | |
| BB- | BB- | Ba3 | |
| B+ | B+ | B1 | |
| B | B | B2 | |
| B- | B- | B3 | |
| CCC | CCC+ | Caa1 | |
| | CCC | Caa2 | |
| | CCC- | Caa3 | |
| CC | CC | Ca | |
| C | C | C | |
| D | D | C | |

Source: Moody's Corporation, and S&P Global Inc.