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Increases in productivity—not artificial increases in labor prices—are the key to economic growth and rising wages. For most of its history, America has enjoyed strong economic growth thanks to the flourishing of dynamic and flexible labor markets. Individuals and businesses in the United States have benefited greatly from this atmosphere, which affords them the freedom to adapt to changing market conditions.

Despite this success, obsolete New Deal–era labor laws and regulations are becoming a drag on the economy. The old adversarial master–servant model of labor relations has little to offer the 21st-century workforce, which is characterized by horizontal corporate structures, significant job mobility, and instant, constant communications. However, rather than adapt to the changing economy, regulators are doubling down on enforcement of outdated national labor policy in a transparent effort to prop up labor unions, major political donors to Democrats.

The National Labor Relations Board (NLRB) and the Department of Labor (DOL) are the key federal labor regulators. Recent regulatory efforts by those agencies have sought to restrict flexible work arrangements and well-established business-to-business relationships, while giving favorable treatment to labor unions in order to aid their organizing efforts. Members of Congress must resist efforts to politicize regulation, adjudication, and legislation in labor relations. The threats are quite real for franchising, temporary staffing, independent contracting and subcontracting, interning, volunteering, supplying, and outsourcing.

REFORM THE FAIR LABOR STANDARDS ACT

The Fair Labor Standards Act (FLSA) is the primary law governing wage and hour mandates across the country, including full-time and part-time private-sector workers and local, state, and federal employees. It sets the minimum wage and overtime eligibility, record-keeping requirements, and exemptions to those requirements. Through the FLSA, Congress delegated broad authority to the Secretary of Labor to issue regulations on the conditions employees must meet to achieve exempt status from the statute's wage and hour requirements, including for minimum wage and maximum hours. Those exemptions are displayed in Section 213 of the FLSA.

Recently, the Secretary of Labor has used that power in an expansive and overreaching manner. For example, in 2016, the Department of Labor (DOL) dramatically raised the salary threshold for an employee to be exempt from overtime pay from $23,660 to $47,476—an increase of over 100 percent. As former DOL Wage and Hour Division Administrator Tammy McCutchen pointed out in congressional testimony, such an increase is out of line with historical raises of the salary threshold. Such significant changes to the rules of the game burden employers with massive costs and create new compliance issues.

In addition to the broad authority it gives to the Secretary of Labor, many of the FLSA's current definitions of employment categories are unclear and outdated. For example, the FLSA requires that an employee must earn more than the above-stated salary threshold and primarily perform "bona fide executive, administrative, or professional" activity to fall within the wage and hour exempt status. However, determining

Congress should:

- Reclaim authority over changes to Fair Labor Standards Act rules that affect millions of workers. Legislation should require that any proposed DOL regulatory change to an exemption from wage and hour requirements has to pass both houses of Congress before the rule is finalized.
- Pass legislation to clearly define the parameters of exempt workers in a way that enables employers to offer innovative compensation packages and allow for flexible schedules without fear of running afoul of the law under some technicality.

whether an employee meets the requirement of "executive, administrative, or professional" employee has become increasingly difficult.

In today's economy, it is more difficult to clearly define employees as either management or rank-and-file workers. The FLSA was created in 1938 and needs modernization. With an ever-changing regulatory landscape, this Depression-era wage and hour statute's requirements are ill-suited to govern today's modern workplace, and create confusion and uncertainty that present challenges to employers' ability to comply with the law.

Expert: Trey Kovacs

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REVERSE THE DEPARTMENT OF LABOR'S OVERTIME RULE

On November 22, 2016, Judge Amos Mazzant, of the Eastern Texas U.S. District Court, issued a nationwide preliminary injunction against the Department of Labor's (DOL) overtime rule. Judge Mazzant ruled that the plaintiffs—21 states—would suffer irreparable harm, including millions in compliance costs that would cause a detrimental effect on state governments' ability to provide public services. The injunction means existing overtime regulations remain in place until the court issues a final judgement. From the language of the ruling, it seems likely that Judge Mazzant would again rule in favor of the plaintiffs in a final judgement on the merits of the case.

Although the DOL could file an appeal, it would be during the twilight of the Obama administration, and the Trump administration likely would drop the case. However, it is possible that the judge could reverse course and deem the rule lawful.

If the DOL's rule ultimately goes into effect, it will raise the salary threshold for paid overtime if salaried employees work over 40 hours. The rule adjusts the threshold from $455 to $913 per week, or from $23,660 to $47,476 per year. That change would force many businesses to make some tough decisions about limiting hours or shifting some salaried employees to hourly status in order to rein in labor costs. It would be particularly problematic for small businesses and entrepreneurs with tight budgets, especially those that seek employees who wish to work longer hours with the opportunity for future gains. Companies without large profit margins and large executive salaries would be the most affected by far.

Congress should:

- Challenge the Department of Labor's final overtime rule under the Congressional Review Act, which authorizes Congress to file a joint resolution of disapproval of federal regulations within 60 days of their being finalized. The rule is invalidated if the resolution is passed by the House and Senate and signed by the President. Congress can override a presidential veto with two-thirds of both houses voting in favor of the resolution of disapproval.
- Include a rider in appropriation bills for the Departments of Labor, Health and Human Services, and Education and their related agencies to defund enforcement of the overtime rule.

Universities and nonprofit organizations would also be negatively affected by this new rule because of their fixed budgets. The University of Kansas is a prime example, with 354 employees would become nonexempt, at a cost to the school of $2.3 million in increased overtime, or $2.9 million to raise their salaries above the threshold. The University of Tennessee predicts a $9 million increase in wages paid, which is equivalent to a 2 percent tuition increase on all students, if the rule were to go into effect.

Nonprofit organizations like Operation Smile—which helps provide cleft palate operations for children— have also expressed concern over the new DOL rule, saying the new rule would affect over 50 percent of its workforce and increase costs by about $1 million. Putting this new rule in perspective, Nancy Duncan, Operation Smile's vice president for human resources, said it would eliminate 4,200 cleft lip surgeries annually, priced at $240 each.

Businesses, universities, and nonprofits will be negatively affected by this new rule. Employees face certain struggles due to this regulation as well. Employees wishing to set themselves apart by putting in extra hours will not have the same opportunities to show their dedication and work ethic, which are typically rewarded.

Expert: Trey Kovacs

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REFORM THE WORKER CLASSIFICATION PROCESS

The Fair Labor Standards Act is the primary law governing wage and hour mandates across the country, including full-time and part-time private-sector workers and local, state, and federal employees. It sets the minimum wage and overtime eligibility, record-keeping requirements, and exemptions to those requirements.

As noted, the definitions of whether an employee is exempt from FLSA minimum wage and maximum hour requirements are antiquated and complicated. They need to be modernized to take into account today's workplace practices. For example, the FLSA demands that an employee must earn more than the above-stated salary threshold and primarily perform "bona fide executive, administrative, or professional" activity to fall within the wage and hour exempt status. However, in today's economy, it is more difficult to clearly define employees as either management or rank-and-file workers.

Another area where the FLSA falls short is in clearly differentiating between employees and independent contractors. The FLSA uses a "suffer or permit to work" standard of employee, which is one of the broadest and most far-reaching definitions of employee under U.S. law.

Worker misclassification happens primarily in one of two ways:

- An employee is inappropriately labeled as exempt from minimum wage and maximum hour requirements.
- An employee is classified as an independent contractor when he or she meets the FLSA's employee test.

Congress should:

- Pass legislation to streamline the definition of employee across federal statutes.
- Pass legislation to enable individuals who prefer the flexibility that comes with contractor status to choose that form of work instead of being forced into an employment relationship.

Instead of taking action to simplify the definition of an employee and reduce confusion over worker status, the DOL issued an administrator's interpretation that effectively defines nearly all work arrangements as falling into the category of a traditional employer–employee relationship.

In essence, the DOL guidance attempts to greatly reduce an individual's ability to undertake work as an independent contractor. Eliminating a form of work is poor policy at any time. Overwhelmingly, workers choose to take independent contractor positions because they value working independently instead of being directed by an employer.

Temporary workers and independent contractors serve an important business function. Many businesses, as in the construction industry, have peak seasons when they need extra workers to complete projects for a short duration. For example, using independent contractors allows residential builders to scale up and hire more workers during the summer, without having to take on permanent staff members whom they would not be able to afford during the winter.

Such a major policy change should be implemented through the Administrative Procedure Act's notice-and-comment rulemaking process, not by agency guidance that does not give affected parties the ability to air concerns over the policy's potential effects. Regulation by guidance document drops new policies on stakeholders without notice and may lead to greater noncompliance because of a lack of familiarity with the policy.

Moreover, it is extremely costly for an employer to misclassify a nonexempt worker as exempt or an employee as an independent contractor, which may incur costs in the form of back pay and legal fees. In FY 2015, investigations by the DOL's Wage and Hour Division resulted in $74 million in back pay assessed on employers. Certainly, some bad actors attempt to short workers on pay, but the DOL's Depression-era wage and hour laws defining who is an employee do not match up with the modern workplace and often lead to penalties based on mere technicalities. That possibility is exacerbated by the DOL's changing the definition of exempt through guidance without reaching out to the stakeholders who must comply with the law.

Expert: Trey Kovacs

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IMPROVE OVERSIGHT OF THE DEPARTMENT OF LABOR'S WAGE AND HOUR DIVISION

Under the Obama administration, the Department of Labor issued 19 major rules during 2009–2015, and a total of 570 rules during 2009–2014, along with precedent-changing guidance documents that significantly alter the rules by which firms must abide. Such prolific regulation creates uncertainty and makes it more difficult for firms to comply with the law. Unfortunately, instead of assisting companies with compliance or slowing down the pace of regulations, the DOL has aggressively enforced its new mandates.

Part of the department's strategy has been developed by DOL Wage and Hour Administrator David Weil. The DOL has set its strategic enforcement strategy's sights on the top of corporate supply chains in order to hold them responsible for ensuring compliance further down the chain. However, that strategy, rather than ensure greater compliance by their small-firm partners, will more likely encourage larger companies to steer clear of contracting with small companies, which are vital to job creation. A better solution is to simplify wage and hour rules by reducing record-keeping requirements and liberalizing employee classifications.

Difficulties in complying with onerous wage and hour requirements are evident in the rapid rise in wage and hour lawsuits. Since 2000, wage and hour lawsuits filed in federal courts have increased by more than 450 percent cumulatively. Since 2012, over 8,000 wage and hour suits have been filed. The volume is only part of the story. Just the lawsuit settlements in 2014 under the Fair Labor Standard Act cost employers $400 million and an average of $5.3 million per settlement, according to a July 2015 study by NERA Economic Consulting.

There is no sign of the DOL loosening its stringent enforcement policies. Since 2014, the DOL has requested significant increases in funding to ramp up its enforcement

Congress should:

- Decrease the Department of Labor's enforcement budget until Congress passes legislation to modernize the Fair Labor Standards Act to simplify worker classification and streamline compliance.

activity. For FY 2017, the Wage and Hour Division requests $277 million to pursue its enforcement strategy.

Expert: Trey Kovacs

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REFORM THE NATIONAL LABOR RELATIONS ACT AND NATIONAL LABOR RELATIONS BOARD

The National Labor Relations Act (NLRA) is the primary federal statute governing private-sector labor relations. It establishes the process employees may use to organize and guarantees workers' right to refrain from doing so. The Act outlines "unfair labor practices," or activity that employers and unions are prohibited from undertaking. The NLRA created the National Labor Relations Board, an independent agency made up of five members, which is in charge of enforcing the Act and overseeing labor union elections.

In 1935, Congress established the National Labor Relations Board as a body made up solely of "three impartial Government members" to represent the public interest in labor disputes under the National Labor Relations Act. However, during the 80-year experiment, almost all NLRB members have had either a business or union background. Consequently, most Board members have a predisposition to favor one side or the other. With nearly all Board members having a bias, the NLRB has been unable to act in an impartial manner, as it was created to do.

Today, the NLRB is composed of five members, traditionally two Democrats, two Republicans, and a chair from the President's party, who determines the partisan balance. As a result, Board policy swings like a pendulum. The Board's case precedent flip-flops in favor of organized labor or management, depending on whether a Democrat or Republican holds the presidency. Worse, even though changes in precedent are made in a purely partisan fashion, federal courts routinely give judicial deference to the NLRB on the basis of the Board members' "expertise." The constantly changing NLRB policy creates immense uncertainty for all stakeholders—employees, employers, and unions.

The National Labor Relations Act sets the rules for union elections and unfair labor practices. However, much of it is outdated and needs reform. The Employee Rights Act, a comprehensive reform measure introduced in the past two Congresses, would go a long way toward bringing labor law in line with the needs of the 21st-century workforce by protecting workers' freedom of choice of whether to join a union and by increasing union accountability. Specifically, it would:

- Protect secret ballots in union organizing elections;

- Enable workers at unionized workplaces to choose whether they wish to retain a union as their bargaining representative; and
- Protect workers and employers from union violence.

Congress should:

- Pass legislation to strip the National Labor Relations Board of its adjudication and rulemaking authority, in order to avoid uncertainty surrounding national labor policy, and vest it on Article III courts.
- Short of stripping the NLRB of its decision-making authority, pass legislation to add a sixth member to the Board. This action would greatly reduce constant change in Board precedent and bring a greater level of stability to labor relations.
- Enact the Employee Rights Act.
- Amend the National Labor Relations Act to (a) guarantee all workers a secret ballot in union elections, (b) require union recertification elections by secret ballot once the workforce has turned over by more than 50 percent since the last election, and (c) prohibit unions from penalizing workers who wish to decertify.

Currently, unions may organize a group of workers in two ways: by secret-ballot election or through a process known as "card check." A secret-ballot election allows workers to cast their ballots in private and free from coercion. Card check invovles union organizers confronting individual workers and asking them to sign a card that acts as their vote for the union. Unsurprisingly, the card-check process opens the door to deception and intimidation of workers. Pressured to sign, workers are deprived of time to hear the pros and cons of unionization and to reflect on whether they want to unionize.

Since employers must agree to card-check elections in place of NLRB-supervised secret-ballot elections, it encourages unions to use a strategy known as a "corporate campaign" to browbeat employers into agreeing to card-check organizing. Corporate campaigns are aggressive, public relations campaigns designed to damage an employer's reputation until it accedes to union demands.

Under the National Labor Relations Act, once a union wins representation over a group of workers, it remains those workers' representative in perpetuity, unless the workers vote to decertify the union. Decertification is an arduous and difficult process that the NLRB is trying to make even more difficult. That provision has led to a number of "inherited unions." Recent research by the Mackinac Center for Public Policy shows that only 7 percent of current union members actually voted for the union representing them. Thus, a vast majority of workers never had a voice in choosing their workplace representation.

Rightly, the NLRA makes it an unfair labor practice by an employer to interfere with the workers' right to organize. The same should be true for unions that attempt to restrain the workers' right to remove an unwanted union. Currently, many union constitutions contain provisions that punish workers who seek to decertify their union, including through steep fines and even termination of employment.

Expert: Trey Kovacs

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OUTLAW UNION VIOLENCE

Although workers should have every right to organize and unions should have every right to try to attract workers to join, some limits must be set on the kinds of activities that are allowed toward this goal. One such restriction should be outlawing union violence. Unfortunately, the U.S. Supreme Court's 1973 decision in *United States v. Enmons* created a loophole in the Hobbs Act, a major federal anti-extortion law, that exempts unions from prosecution for violence committed in the course of promoting union goals. Since 1975, the National Institute for Labor Relations Research has collected more than 9,000 accounts of union violence reported in the media.

Congress should:

- Close the loophole that exempts union violence from the Hobbs Act via the Employee Rights Act.

Expert: Trey Kovacs

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PREVENT IMPLEMENTATION OF THE NLRB'S AMBUSH ELECTION RULE

In April, 2015, the National Labor Relations Board amended its rules governing unions organizing elections in a way that will limit debate concerning the pros and cons of union representation, thereby limiting workers' ability to cast an informed vote. The rule shortens the time frame between the filing of a petition and the date on which an election is conducted to as few as 14 days. This rule is both unnecessary and unfair to voters wishing to educate themselves on the merits of union representation. In FY 2013, the median time frame from petition to election was 38 days, with unions winning 64 percent of organizing elections, dropping to a median of 33 days in FY 2015, with unions winning upward of 70 percent of elections, according to the NLRB.

Furthermore, the rule compels employers to provide union organizers with employees' contact information. This provision is highly troublesome for privacy concerns and can lead to harassment. For example, the Communications Workers of America obtained one woman's information and subscribed her to thousands of unsolicited magazines. She was inappropriately billed for those subscriptions and then had to spend hours of her own time to unsubscribe from them. The NLRB itself has recognized the adverse results of the rule, including "[(1)] selling the list to telemarketers, (2) providing it to a political campaign, or (3) using the list to harass, coerce, or rob employees."

Congress should:

- Defund the enforcement and implementation of the NLRB's ambush election rule.

Expert: Trey Kovacs

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Trey Kovacs, "Federal Labor Agencies Ambush American Economy," *OnPoint* No. 205, Competitive Enterprise Institute, August 27, 2015, https://cei.org/content/federal-labor-agencies-ambush-american-economy.

PREVENT IMPLEMENTATION OF THE NLRB'S NEW JOINT EMPLOYER STANDARD

In August 2015, the National Labor Relations Board unilaterally changed the definition of joint employment in a way that could expose tens of thousands of businesses across the United States to increased costs and liability. The NLRB's action will:

- Block a path toward entrepreneurship;
- Reduce job creation;
- Expand employer liability;
- Increase employment insurance costs;
- Lead to a surge in lawsuits; and
- Disrupt thriving business models.

The underlying motive of the NLRB's move is to ease union organizing.

Traditionally, joint employer liability was established when one company, normally the larger one, exercised *direct* and *immediate* control over the employees of smaller companies with which they contract. Under the new standard, a company may be held liable for labor violations by other employers they contract with, by merely exercising *indirect* control or possessing *unexercised potential* control over the other company's employees.

As a result of the change the increased liability imposes on employers, the NLRB's new joint employer standard puts a wide swath of proven, established business models at risk, including franchising, the contracting out of a business's noncore functions, and the use of temporary staffing agencies. Those industries create thousands of jobs annually and generate opportunities for entrepreneurs to start new businesses. The NLRB's new joint employer standard will result in reduced opportunities for entre-

Congress should:

- Defund enforcement of the National Labor Relations Board's joint employer standard through appropriations bills for the Departments of Labor, Health and Human Services, and Education and related agencies.

preneurs and fewer jobs by making larger firms liable for the employment practices of entities it may be unable to control.

Expert: Trey Kovacs

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PROTECT WORKER PENSIONS BY REFORMING THE PENSION BENEFIT GUARANTY CORPORATION'S MULTIEMPLOYER PROGRAM

The Pension Benefit Guaranty Corporation (PBGC) is a federal agency that insures private-sector pensions. Created by Congress in 1974 as part of the Employee Retirement Income Security Act, the PBGC has become so entrenched in the pension insurance firmament that it has crowded out private alternatives for securing worker pensions. Although the PBGC's insurance program is funded through premiums paid by insured companies, not federal tax dollars, the premium amounts are set by Congress and do not reflect the riskiness of individual pension plans. Consequently, the premiums are too low to cover anticipated payouts. In effect, the program now functions as a huge subsidy to businesses and unions that threatens to make taxpayers liable for billions of dollars in private-sector pension losses.

Artificially low premiums are bad enough. But the way the PBGC treats multiemployer pension plans—those maintained by several employers, usually in related industries, to cover members of a labor union or collective-bargaining unit—is even worse. The PBGC's multiemployer pension insurance program insures the pensions of more than 10,000 employees in about 1,400 pension plans set up under collective-bargaining agreements and run by labor unions. Under the PBGC's single-employer plan, only the company that promises benefits to its workers is liable for paying those benefits. But under the multiemployer plan, every participating employer is potentially responsible for covering the promised benefits of other participating employers that go out of business.

Under that arrangement, the PBGC poses a textbook illustration of moral hazard driven by perverse incentives—a situation colloquially known as the "last man standing rule." Economically distressed companies have an incentive not to pay premiums in order to push their costs onto other participating firms, and those added costs tend to make the other participant companies less healthy.

The PBGC's multiemployer plan also caps benefits at a much lower level, $12,870 a year, compared to $60,136 for the single-employer plan. Because of that lower cap and the fact that "orphan" pension plans are first taken over by other participating employ-

Congress should:

- Raise PBGC premiums in the short term.
- Give the PBGC the flexibility to adjust premiums for the multiemployer program to reflect risk in the future, as PBGC's single-employer program and the Federal Deposit Insurance Corporation does for their premiums.
- End the special treatment for multiemployer plans and require them to follow the same rules as single-employer plans, including specified discount rates.
- Require the PBGC to take over failing multiemployer plans.
- Oppose any PBGC bailout proposals.

ers, the PBGC's multiemployer plan has much lower premiums than its single-employer plan—currently $26 per year, compared to $57 for the single employer plan.

For its multiemployer program, the PBGC recently reported a $42.4 billion deficit for FY 2014, and that deficit is projected to grow to $53.4 billion by 2025. Worse, in 2025, the PBGC's multiemployer program is projected to become insolvent. With massive new liabilities from some very large plans that are projected to become bankrupt within the decade, the PBGC's multiemployer program will be paying out about 10 times as much in benefits as it takes in through premium revenues. This will quickly drain the PBGC's budget, and absent significant reforms or a taxpayer bailout, the agency's multiemployer program will only be able to pay about 10 percent of its insured benefit level. This would reduce the maximum benefit for a worker with a 30-year work history from its current level of $12,870 per year to only $1,500. The combination of the collapse of many multiemployer pension plans, along with the PBGC's threatened insolvency, could be financially catastrophic for many pensioners.

That deficit is clearly unsustainable, and taxpayers could be forced to cover billions of dollars of eventual losses.

PBGC premiums are set by Congress, which makes no effort to take the risk of private pension plan default into account when setting those premiums. That omission undermines one of the most important purposes of insurance premiums: pricing risk, as determined by market signals, in order to deter risky behavior. The beneficiaries of those low premiums—primarily unions and large unionized firms—lobby to keep those premiums low, because artificially low premiums act as a huge subsidy. All pension plans are treated the same, regardless of their solvency.

To make pension insurance truly sustainable, Congress should not simply raise premiums to some other legislatively determined level, but instead give the PBGC the flexibility to adjust its own premiums on a risk-related basis, as the Federal Deposit Insurance Corporation does. Lawmakers should not be in the business of setting prices, and they should not make an exception for pensions, especially for an insurer supposedly funded by premiums.

For the beneficiaries of that de facto subsidy, defending it publicly requires some rhetorical sleight of hand. For example, the Pension Coalition, a group of large companies and trade associations opposed to PBGC premium increases, denounces risk-based premiums as a "tax" on employers. In reality, raising premiums, even steeply, amounts to the removal of a subsidy—a solution that can be made permanent only by Congress getting out of the business of setting the PBGC's premiums.

Severely underfunded plans that cannot realistically meet their existing obligations should stop digging themselves into a fiscal hole. The Department of Labor deems a pension plan "endangered" if its funding level is less than 80 percent of what it needs to meet its payout obligations, and it deems a plan "critical" if it is funded below 65 percent. Congress should also require the PBGC to take over multiemployer plans that reach critical status, close them to new entrants, and pay current beneficiaries to the extent possible.

Pension plans use discount rates to determine the level of direct present contributions needed for the plan to meet its obligations in the future, minus the expected returns on the plan's investments. Pension payout obligations are fixed; they do not go away and often increase over time. Given that reality, pension plan managers should base discount rates on conservative investment return projections. Yet pension managers face a perverse incentive to base discount rates on overly optimistic rates of return, because such optimistic rates lower their current contribution amounts. Currently, multiemployer plans can use whatever discount rate they choose. Instead, they should be required to use the same discount rates used by single-employer plans.

The U.S. government is not directly responsible for the PBGC's unfunded liabilities, but the agency's massive, mounting deficit makes a federal bailout a real possibility. In fact, some politicians have already proposed such a bailout. A bill introduced in the 112th Congress by Sen. Robert Casey (D-Pa.) sought to make the federal government explicitly liable for multiemployer plans under the PBGC's purview. The bill failed, but similar schemes could come up again, especially if the PBGC's deficit were to get much worse. Congress should resist any attempt at a bailout.

Expert: Ivan Osorio

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PROTECT STATE AND LOCAL TAXPAYERS BY PROMOTING BETTER PUBLIC PENSION GOVERNANCE

Limited government is essential to prosperity. Conversely, having to pay for a large and growing public sector puts considerable strain on taxpayers and curtails entrepreneurial activity by diverting capital away from the private sector. At the state and local level, that has become a major problem, with states and municipalities promising government employees generous health and pension benefits but failing to fund them adequately. As a consequence, many local governments are facing large public pension shortfalls that threaten large future tax increases and cuts in public services—and a less favorable business environment.

One important factor contributing to public pension underfunding is dubious accounting facilitated by the Governmental Accounting Standards Board (GASB), the independent, quasi-private organization that issues accounting standards for state and local governments. Although state and local pensions are not a federal matter, the size of many pension shortfalls could likely lead to calls for federal assistance. Congress should resist such calls and work to expose the causes and scope of the underfunding problem.

For years, GASB allowed public pension managers to calculate employer contributions using discount rates based on overly optimistic projected investment returns, usually in the 7 percent to 8 percent range. Although some pension funds can achieve such return rates in some years, they rarely do so year after year. To be sustainable, low returns in any given year have to be offset by very high returns (far higher than 7 percent or 8 percent) in most other years in order to keep up with the growth in pension liabilities, which rise in an uninterrupted straight line. Given the fixed nature of public pension liabilities, pension managers should use a more realistic, risk-free rate, based on investment return projections consistent with 15- to 20-year Treasury bonds, in the 3 percent to 4 percent range.

Congress should:

- Hold hearings aimed at clarifying the Governmental Accounting Standards Board's decision-making process in setting discount rates of public pension plans.
- Resist calls for bailing out underfunded state public pensions.

The Governmental Accounting Standards Board reformed its pension accounting standards in June 2012, when it approved GASB Statements 67 and 68, to replace GASB Statements 25 and 27. Under the previous standard, pension plans could base discount rates not on the certainty of liabilities coming due, but on the projected returns on plan assets. Although it was a small step in the right direction, the reform did not go nearly far enough, for two reasons.

First, the new GASB standards allow for two different discount rates, depending on a plan's ability to pay its obligations.

Second, a plan's ability to make its payout obligations is determined for individual years, not over the long term. Plans must pay pension benefits to current retirees at the same time they are accumulating new obligations to pay today's workers in the future. Therefore, constant payouts reduce the balance on which future investment returns can be earned. Thus, thinking only of long-term average growth rates is misleading.

Plans whose "fiduciary net position" is sufficient to meet their obligations in a given year may continue to use their investments' projected rate of return, much as under the older, GASB Statement 25 standard. A GASB fact sheet on Statements 67 and 68 states, "This asset-based rate is appropriate because the earnings on the plan's investments reduce the amount an employer will need to contribute to the plan." But that is precisely the problem. The new standards treat pensions as though they were pay-as-you-go plans, by basing contributions on short-term obligations. In the end, lower short-term contributions lead to long-term shortfalls. Thus, a plan that can meet its obligations one year may be unable to do so in the future.

By contrast, GASB calls on plans that are unable to meet their obligations in a given year to use a discount rate based on a 20-year tax-free municipal bond. Given the fixed nature of pension obligations, such a risk-free rate should be standard for pension contributions across the board. GASB's adoption of a dual discount rate makes little sense. Congress should seek to find out why GASB adopted this standard before state and local officials come to Capitol Hill seeking a pension bailout.

Expert: Ivan Osorio

For Further Reading

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