Not Easy, But Worth It

Lawmakers spent the past five years shoring up public retirement plans.

BY RON SNELL

he battering state budgets have taken in the past few years has drawn more public attention to another huge financial issue: public pension systems.

There are 24 million active and retired members of state pension systems. When markets plunged two years ago, the assets in those systems were pummeled. Newspaper headlines since have raised alarms about the solvency of the systems and whether states are dealing with the issue adequately.

State lawmakers have engaged in a flurry of activity in 2010 to address concerns in their public pension systems. No year in memory has seen as many significant retirement bills enacted as this year.

Colorado cut back previously promised post-retirement increases for people who have already retired. Illinois increased the normal retirement age to 67, probably a first for state plans. Utah completely redesigned its retirement plans. Virginia and Wyoming converted noncontributory plans to ones that require employee contributions.

Illinois Senator Donne Trotter says risk containment and balancing intergenerational costs were key to his state's 2010 revisions—the same impetus for reforms across the country.

"How do we protect the next generation? How do we balance costs between this generation and the next?" he asks.

By May, 11 states had enacted major changes to increase employee contributions, restrict or eliminate future cost-of-living adjustments, increase age and service requirements for retirement, cap benefits, and tighten rules for retired people who want to return to government work. They include Colorado, Illinois, Iowa, Michigan,

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Minnesota, Mississippi, New Mexico, Utah, Vermont, Virginia and Wyoming. Benefit increases have been almost nonexistent, though putting retirement systems on a more solid footing is a benefit for everyone.

States have not just now awakened to the problem. In fact, lawmakers have been aware of and studying it since the middle of the decade. In the last five years, many have increased employee contributions, lengthened how long employees need to work to receive benefits and changed cost-of-living increases.

RADICAL AND CONSERVATIVE

These changes can be seen as radical, or they can be seen as conservative.

For decades, states have made retirement



SENATOR

DONNE TROTTER

ILLINOIS

plans more flexible and generous. Before 2000, legislatures regularly improved the benefit packages—reducing the time it took to earn a pension, increasing the amount of salary a pension would replace, protecting benefits against inflation, and easing the restrictions against retiring and coming back to work, often called double-dipping.

Reversing this trend is a radical change in direction. But that is exactly what states have been doing.

"We have to ensure we can meet 100 percent of the commitments we've made," says Utah Senator Daniel Liljenquist, explaining the reasoning behind the changes. "We have to remove the risk of bankrupting the state."

But the changes are also conservative. They preserve the structures of the past. Although half the states have made significant changes in retirement plans since 2005, only Alaska, Georgia, Michigan and Utah have changed the basic structure of statewide plans.

CHANGE IN PLANS

When the private sector began to abandon traditional, defined benefit plans for 401(k) plans in the early 1980s, state and local governments considered moving in the same direction.

A 401(k) plan is a defined contribution plan. It does not guarantee an annuity based on compensation and length of service, but instead allows participants to convert their account to an annuity at retirement. The amount of the annuity depends on the con-



SENATOR

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tributions employers and employees have made and how well the investments have done. It moves the risk from the employer, who bears it in defined benefit plans, to the employee.

Traditional benefit plans are too expensive, place too much burden on taxpayers, and lack the flexibility of 401(k) plans, say advocates of defined contribution plans.

There are a few state models. Nebraska had a defined contribution plan for state employees between 1967 and 2002, when it changed it to a cash-balance plan to provide better investment returns for members. West Virginia began enrolling teachers in a defined contribution plan in 1990. It was replaced with a traditional defined benefit plan in 2005, again because members were experiencing such small investment growth that they would be poorly prepared for retirement. Michigan started placing state employees in a defined contribution plan in 1997. A few states offer both a defined contribution plan and a defined benefit plan for all members. In the 1990s, other states began offering defined contribution plans as an option employees—and in rare instances, teachers—could choose. But the general practice in state and local government is unchanged: 91 percent of full-time state and local government employees are covered by a traditional, defined benefit retirement plan.

The funding for those plans reached an historic high in 2001 when 31 of the 73 statewide funds that use the most widespread form of accounting method reported assets that were more than 100 percent of their accrued liabilities—the amount they eventually would have to pay beneficiaries. Another 18 reported assets between 90 percent and 100 percent of accrued liabilities. Since experts advise a ratio of 80 percent, these were impressive.

It's unlikely those kind of ratios will be seen again soon. Sixteen of the 31 states that had broken the 100 percent line in 2001 reported ratios above 80 percent in 2009. Only the Delaware Retirement System was close to 100 percent. Two other plans in Indiana and North Carolina were also above 90 percent.

Such dramatic changes have focused a spotlight on public retirement. A 2010 report, "The Trillion Dollar Gap" from the Pew Center on the States, reaped a media harvest when it contended the pension funding crisis began in 2001 and was the result of state neglect over time, as well as the recession of 2007-2009.

Some academic studies assert legislatures and public fund managers have aggravated the problem with unrealistic estimates of what trust funds can earn over time. Others argue defined-benefit



pensions are outmoded, overly generous and too expensive, and should be replaced with retirement policy closer to the private sector model—these days, predominantly individual retirement accounts on the lines of a 401(k).

STATE ACTION

By NCSL's count, 18 states changed retirement plans from 2005 through 2009 by:

- ◆ Increasing employee contributions.
- ◆ Determining retirement benefits by calculating salaries over a longer period of time.
- ◆ Increasing the age or service requirement, or both, for eligibility.
- ◆ Adding an anti-spiking provision.
- ◆ Reducing or controlling post-retirement cost-of-living adjustments.

Returns on investments are not the only problem retirement plans face. Earlier retirement ages, the greater longevity of the population, ill-conceived early retirement incentive plans, and contribution holidays all have hurt. If plan managers failed to keep longevity and mortality statistics up to date, that hurt as well. The shocks brought by the recession of 2001-2002 and demographic changes account for the pension plan changes between 2005 and 2009.

Alaska, Georgia and Utah have had different reasons for moving from defined benefit plans to alternatives. According to the Alaska Division of Retirement and Benefits, serious discussion of change began in 2002 over concerns about the huge liabilities—\$4.2 billion—the state bore in the early years of this century for its public employees' and teachers' plans. Actuaries at the time recommended increasing employer contributions from less than 7 percent to almost 25 percent of salaries, and to 35 percent for the teachers' plan. The risk and volatility associated with funding a defined benefit plan appeared no longer sustainable.

This year, Utah lawmakers also saw the liabilities of defined benefit plans as too challenging to sustain.

"Risk containment was very much on our minds," says Liljenquist, sponsor of the legislation that reshaped Utah's retirement plan. "With investment losses, our costs would have gone from \$400 million to \$800 million a year. We had to look at what we could afford, and what it could buy."

Lawmakers decided Utah could afford a contribution of 10 percent of employees' salaries, which buys a choice for new employees. They can pick a defined contribution plan to which their employers will contribute the



SENATOR

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GEORGIA

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10 percent a year, or they can pick a reduced defined benefit plan to which employees will have to contribute if the state's contribution turns out to be inadequate. With the second option, employees also gain an individual account in which the employer deposits any amount of the 10 percent contribution not needed for the defined benefit portion.

"Ten years from now," says Liljenquist, "we should be able to absorb any economic hit. We'll be in great shape in 20 years, and in 30, we'll have removed any risk of state bankruptcy."

EMPLOYEE CONTRIBUTIONS INCREASE

Georgia ended its defined benefit plan for state employees in 2008 in favor of a plan that resembles the second choice in Utah, but for very different reasons.

"We had difficulties in attracting and retaining the best and brightest employees" with the traditional retirement plan, says Senator Bill Heath, who sponsored the legislation in 2007. "The emerging workforce focuses on current cash flow. We were high on benefits but low on salary."

That led to a nearly 21 percent turnover among workers in their first five years in state government. At the time the plan was adopted, fiscal concerns were minimal: Georgia's retirement plans have long been among the best-funded. The new plan reduces pen-



REPRESENTATIVE
MARK FERRANDINO
COLORADO

sion costs for the state, but Heath emphasizes the change was to attract young workers to state employment.

While most states have stayed with traditional retirement plans, Georgia has moved to substantially more cost-sharing with employees. At least seven states have increased employee contributions this year, sometimes for current employees as well as for new ones. Utah's restructuring, too, places more responsibility on employees. Measures that delay benefits until a later age, provide lower benefits as a percent of salary, or cap post-retirement cost-of-living adjustments also shift responsibility to members by eventually providing a smaller benefit than current laws do.

"We've made difficult choices to deal with these shortfalls," says Colorado Representative Mark Ferrandino, a member of the Joint Budget Committee. "Colorado's changes were a bipartisan effort to ensure that the pension fund is actuarially sound. This effort took shared sacrifices from retirees, current and future employees."

Colorado's legislation reduces the postretirement cost-of-living adjustments for all retirees from the percentages previously promised, reduces benefits for people who retire in the future, and increases contributions from the salary of current members.

These measures are not expected to solve all the funding problems of pension systems. States with large unfunded liabilities still have to deal with them. But there's a lot to be said for controlling costs going forward. Not least of which is the way legislatures demonstrate the seriousness of their approach to broad state fiscal issues.

"As we grapple with unprecedented deficits, we have to look at how we run government," says Illinois' Trotter. "Pension reform is a significant part of how we do business going forward."

CHECK OUT more about legislation to address public pensions from the 2010 sessions

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