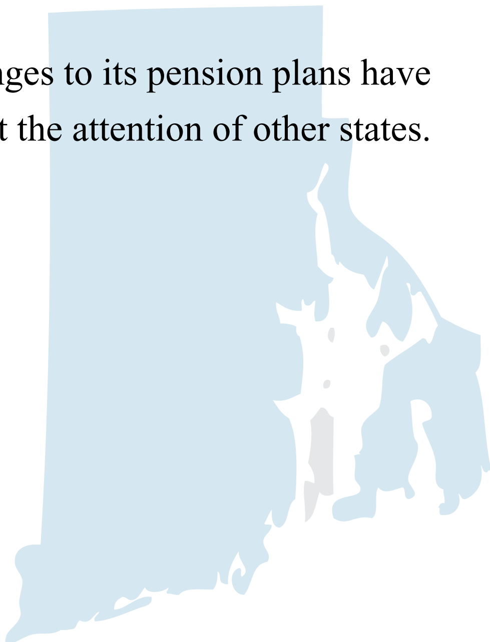
LESSONS FROM RHODE ISLAND



Bold changes to its pension plans have caught the attention of other states.

BY RON SNELL

Tough times in Rhode Island may end up helping other states, at least when it comes to pensions.

Lawmakers in the Ocean State, confronted with one of the worst-funded pension plans in the nation, have gone further than any other state in making significant changes and applying them to almost all current state and local employees.

"It would certainly be a lot easier to walk away from this reform," Senate President Teresa Paiva Weed said after the vote. "However, it is clear that doing nothing only puts our retirees' and our active members' benefits at greater risk. We owe it to them, as well as to all other taxpayers, to attack this challenge head on."

Senate President Teresa Paiva-Weed Rhode Island

It's a move other legislatures are watching as they grapple with their own pension problems.

Of the 41 states that have enacted major state pension reforms in 2010 and 2011, Rhode Island stands alone. No other state has set out to change its plan for state employees and teachers the way Rhode Island has. Legislation passed in November moved current members in the traditional defined benefit plan to what's called a "hybrid" model that supplements the traditional plan—at a reduced level of benefits and costs—with an individual account similar to the 401(k) plans common in the private sector.

Adopting the hybrid plan was significant but not unprecedented. Indiana has had a hybrid system for more than 60 years, and Michigan and Utah adopted such plans in 2010. The novelty of what Rhode Island lawmakers did lies in moving current members into the new plan.

There are constitutional and legal constraints on states' ability to change pension plan coverage for people who already are members. The constraints differ greatly from state to state, and few have been tested in courts. Legislatures and governors move cautiously toward these restraints, however, and, until Rhode Island took its action, have never applied major pension plan changes to current employees and retirees. Massachusetts, for example, enacted legislation in November that raises retirement ages and reduces eventual benefit packages. It will apply only to new members of the system.

Policymakers who have been bold in raising current employees' contribution requirements and changing post-retirement cost-of-living adjustments have encountered legal challenges as a result. States facing actual or threatened lawsuits include Arizona, Colorado, Florida, Minnesota, New Hampshire, New Jersey, New Mexico, South Dakota and Washington.

Big Trouble

Rhode Island lawmakers did not lightly or without good reason move into new territory. The state is awash in troubles. Some of them, like high unemployment and decay of its former manufacturing base, are shared with many other states. Others, however, are more peculiar to the state. Rhode Island's small population—1.05 million in 2010—is barely growing and is a little older than the U.S. average. Its pension plan, for the size of the state, has been among the worst-funded. Although the legislature has made many changes to shore up its pension plans, a sea of red ink has flooded the balance sheet.

A summary of the enacted legislation states Rhode Island "is struggling to emerge

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from its most recent economic downturn, dealing with high unemployment, sluggish real estate markets, and structural deficits in its five-year forecast. Recent economic forecasts suggest the state is not likely to grow its way out of the problem." Much the same could be said for other states. In California, for example, Governor Jerry Brown has proposed pension reforms with some of the same provisions enacted in Rhode Island, including a hybrid plan.

Rhode Island lawmakers, like those in other states, were concerned about the rapidly growing unfunded pension liability. Before the legislation passed, the forecast for growth from FY 2012 to FY 2013 was from $4.7 billion to $6.9 billion, a foreboding rate of 47 percent. This was due, in part, to lower and more realistic assumptions about future investment returns. At a time of slow revenue growth, that increase in the pension obligation would have demanded a growing share of state and local government general funds.

The importance of Rhode Island's initiative can hardly be overstated. By changing how employees accrue benefits and reducing future cost-of-living adjustments for current and future retirees, the legislation hits many nails on the head.

- The state retirement plans' unfunded liabilities fall from $7.3 billion to $4.3 billion.
- The estimated state and local government contributions for FY 2013 fall almost 40 percent, from $689 million to $415 million.
- The costs of restructuring are shared by all: retired workers, current employees and new hires.
- All benefits earned in the past are protected.

Chipping Away at the Problem

Before the Rhode Island legislation, state lawmakers around the country had taken a more gradual approach, changing benefits for future hires, reducing cost-of-living adjustments for retirees and increasing employee contributions. Higher employer contributions are always an option, of course, but currently an impractical one in most states.

Six states have reduced the schedule for cost-of-living increases for retirees in the last two years, and six others have done so in ways that will affect current employees when they retire. Since cost-of-living increases are expensive, reducing them provides immediate savings and a long-term reduction in the total liabilities of a pension plan. Is this legal? All three of the states that reduced cost-of-living adjustments in 2010 were sued, and suits over the 2011 legislation certainly are possible. Courts in Colorado and Minnesota ruled in favor of the reductions, although the Colorado decision will be appealed.

Another way to reduce pension system liabilities immediately is to increase contributions. Employers' ability to contribute more is limited by the dire fiscal conditions of state and local governments, so, not surprisingly, 25 states increased only employees' contributions in 2010 and 2011. In all but six of these, the increases affect current members of retirement plans. In a few states, such as Iowa, this represents a long-term practice. In others, such as California and Vermont, negotiations with unions have led to an agreement on the contribution increases. Other states—Wisconsin and Wyoming, for example—have ended a long-term practice of employers' "picking up" the employee contribution and have passed it back to employees. Some of the increases, such as those in Florida, have been challenged based on state law and previous court decisions.

Defining Benefit Plans

Not all the increases in employee contributions will benefit retirement plans, since in at least 10 states, employee increases are merely making up the loss from reductions in employer contributions. Such offsets help state and local government budgets, and they help equalize employee and employer contributions. Some experts believe increasing employees' stake in the well-being of their retirement plan is a desirable goal.

"As a general rule, public employees should pay at least half the normal cost of their benefits," says Girard Miller, a pensions expert and senior strategist with the PFM Group.

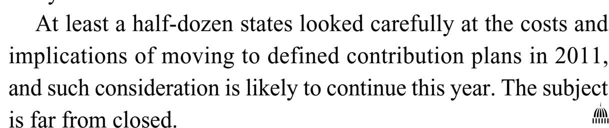
"It would certainly be a lot easier to walk away from this reform. However, it is clear that doing nothing only puts our retirees' and our active members' benefits at greater risk."

—Rhode Island Senate President Teresa Paiva Weed

Most of the changes governors and legislatures have made in state retirement plans in the past decade have preserved the traditional "defined benefit" plan that awards retirees life-long annuities based on their length of service and final salary. Many states have considered shifting to a defined contribution plan—most commonly used in the private sector—in which an employer contributes a fixed annual amount but the final benefits are not guaranteed. In most cases, however, they have chosen not to, in part because such a change does nothing to address any existing unfunded liability and because of employee resistance.

Rhode Island added itself to the relatively short list of states that have moved away from defined benefit plans in recent years. It may not be the last to do so. A joint study commission in Kansas has been considering whether to recommend a new plan structure to the Legislature. California's Brown has recommended a hybrid plan, and it's possible a group called California Pension Reform may put a hybrid plan on the California ballot this year.

At least a half-dozen states looked carefully at the costs and implications of moving to defined contribution plans in 2011, and such consideration is likely to continue this year. The subject is far from closed.



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