State Pension Reform in 2010 and 2011

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Efforts to solve the funding problems of state retirement plans produced a record amount of state legislation in 2010 that may turn out to be a prelude to an even more legislation in 2011. In 2010, 21 states enacted changes in their public pension plans, ranging from restricting the ability of retired people to return to a job covered by a public pension to completely restructuring plans. The changes reflected some recent developments, particularly the financial losses the Great Recession imposed on trust funds, but longer-term issues were in the mix as well.

By the end of the first decade of this century, state retirement plans had suffered an enormous reversal from their financial status in 1999, when funding for 126 statewide retirement plans (including the District of Columbia) reached a record high—on average, 103 percent of accrued actuarial liabilities. Two recessions battered the plans' assets. State budgets were undermined by the same recessions and the states' slow recovery from the one of 2007-2009 made it impossible for them to rebuild pension system assets. Some systems have suffered additionally from long runs of inadequate state contributions and inadequately funded increases in promised benefits. For 2009, analysts at the Boston College Center for Retirement Research estimated the average funding ratio for the same 126 plans was 78 percent. [1] Other analysts report similar numbers.[2] Those ratios, however, depended on accepting state retirement plans' assumptions about the value of their assets and the future investment return on them. Skeptics viewed the plans' assumptions as unduly optimistic and contended that some retirement funds are so poorly funded, when correctly valued, that they may run out of assets within a decade.[3]

The financial condition of retirement plans was one concern in 2010. Added to it were the aging of the state workforce and its increased propensity to retire, the inability of state budgets to accommodate higher employer contributions for years to come, questions about the different retirement policies of the private and public sector, and a climate of opinion that questioned public employee compensation compared to the grim outlook for employment, retirement benefits and health insurance in the country overall.

Legislation of 2010

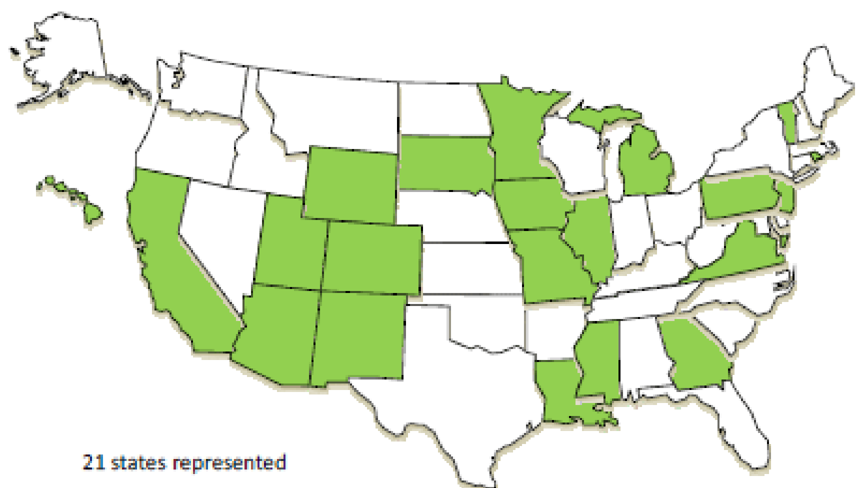
These issues resulted in a record amount of 2010 legislation to restructure the contribution and benefit provisions of state retirement plans as legislatures accepted the challenge of making state retirement plans sustainable over the long term.

Figure 1 shows the 21 states that enacted pension reform legislation that affected future benefits or contribution requirements for at least one statewide retirement plan for state employees or teachers in 2010.

These changes included:

- Eighteen states increased required employee contributions or age and service requirements for pension benefits, or both. In the six legislative sessions combined, from 2005 through 2009, only 17 states had taken such actions.
- Twelve states increased the amounts members must contribute to their retirement plan. In seven states, the increase affected current employees and in five will affect only new hires. Four states (Missouri, Utah, Virginia and Wyoming) previously had not

Figure 1. Major State Pensions Legislation Enacted in 2010



required contributions for employees or had provided that employers would pay what was nominally an employee contribution. In Utah, the contribution requirement will come into effect only under certain actuarial situations.

- Eleven states enacted higher age and service requirements for pension benefits, generally only for new hires. However, in Vermont, the higher requirements will affect teachers who are more than five years away from retirement eligibility. In Colorado, the changes affect members of the Public Employee Retirement Association who have less than five years' membership.
- Eight states reduced the amount of post-retirement benefit increases they will pay retired people in the future. In four states the reduction will affect only new hires when they eventually retire. In Rhode Island, the policy will affect current members with fewer than 10 years of membership, and in Colorado, Minnesota and South Dakota, the reduction will affect people already retired as well as future retirees. The legislation is facing legal challenges in each of those last three states.
- Eight states extended the periods over which a person's compensation is averaged for calculating final average salary (final average compensation), which is the basis for pension benefits. A longer period usually means a lower base for the benefits. Generally states extended the period from 36 months to 60 months.
- Nine states reduced benefits available to those who take early retirement.
- Nine states imposed greater restrictions on retirees who return to employment that is covered by the retirement plan from which they are receiving a benefit.

Almost all the 2010 legislation was within the framework of traditional defined benefit (DB) retirement plans, the standard retirement provision in the public sector despite its increasing rarity in the private sector. Two states broke with tradition to adopt fundamentally restructured plan designs –Michigan for the School Employees Retirement System, which includes teachers and other school employees, and Utah for all state and local government employees.

The Michigan plan includes these provisions:

- The new plan replaces a DB plan for employees hired after July 1, 2010 with a combined plan (sometimes called a hybrid plan).
- It includes a defined benefit plan with higher age and service requirements and a lower benefit than the former plan.
- Additionally, for all members, it includes an opt-out defined contribution (DC) plan, with an employer match (4-year vesting) to employee contributions. Within limits, school districts may negotiate levels of employee contributions and employer match.
- There will be no post-retirement benefit increases for the DB portion of the plan.

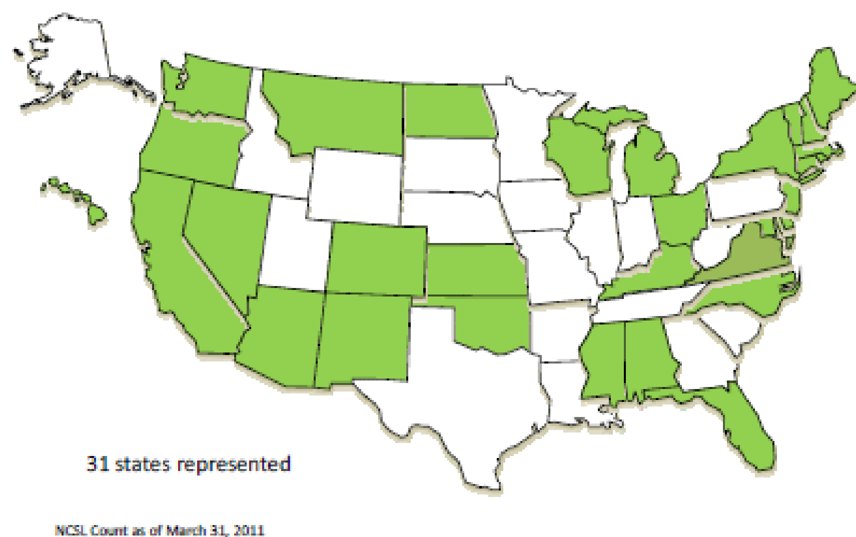
The Utah plan will offer new employees a pair of choices.

- One is a straightforward DC plan, like those in the private sector, to which the employer will contribute 10 percent of compensation for general employees and teachers, and 12 percent for public safety employees. Although employees are not required to contribute to the plan they may do so if they wish. There will be no employer match for any contributions employees make.
- The second possible choice, and the default plan for those who fail to make a choice, is a combined plan with a DB and a 401(k) component. Employers will contribute 10 percent of compensation (12 percent for public safety employees) to the DB element. Employees are not required to contribute unless the employer contribution is inadequate to maintain the actuarial soundness of the plan's trust fund. In that situation, employees will be required to make up the shortfall. In the event that the employer contribution is more than is needed to maintain the actuarial soundness of the plan, the unneeded share of the employer contribution will be deposited in a 401(k) account for each employee. Employees may contribute to their 401(k) plan, but are not required to do so.

Utah became the first state to adopt a defined contribution plan for public employees, even as an optional plan, since Alaska did so in 2005. The legislative record for 2010 can be seen as radical or conservative: radical since more states than in any other year shifted substantial slices of their pension obligations to public employees, or conservative, in that they did so almost entirely within the traditional public pension framework.

The Outlook For 2011

2011 could break the 2010 record for substantial state pension legislation. There's no fully satisfactory way to measure the activity to date, but significant proposals for reform have surfaced in at least 31 states, originating with pension commissions active since the end of 2010 legislative sessions, governors' 2011 budget and policy proposals, and legislation sponsored by the leaders of legislative chambers and the chairs of pensions and retirement committees. Figure 2 shows the 31 states.



These are among the proposals for 2011 action, not all of which have been drafted as legislation:

- Higher employee contributions in 18 states, with proposals for higher contributions from current members of the workforce in 14 of those states.
- Increased age and service requirements for retirement benefits in 10 states.
- Greater limits on early retirement benefits in seven states.
- Reductions in or repeal of post-retirement benefit increases in five states.
- Proposals to replace traditional plans with defined contribution plans in at least six states.

The most noteworthy item in that list is the number of legislatures considering higher employee contributions for current employees—14 of them, with four more considering higher contributions only for future employees. This item and the significant number of states reviewing their policies on post-retirement benefit increases speak to the urgency of improving state retirement systems' cash flow. The savings from changes in other benefits or in requiring people to work longer to receive a benefit can be substantial, but they accrue gradually in the future. Contribution increases and reduced payments for benefit enhancements affect retirement plans' balance sheets when they go into effect.

Some of the changes included here would not have that effect. Legislation enacted in New Mexico and Wisconsin offsets requirements for higher employee contributions with reduced employer contributions. This legislation, like additional proposals in Colorado and Maine, is intended to help balance the state general fund budget, not to address pension funding issues. By and large, though, the proposed employee contribution increases would flow to pension systems without reductions in employer contributions, and have the effect outlined.

The proposals for shifts to defined contribution plans also are significant. This report mentions six because of the criterion for inclusion that such proposals originate with governors, legislative leaders or pension study commissions. Most states see such legislation filed and killed annually. These proposals come from sources that ensure them a hearing even if the proposals also are killed – the Virginia Senate Finance Committee rejected the governor's proposal for an optional defined contribution retirement plan three times in 2011. In the fiscal and political climate of 2011, such proposals for fundamental change in state retirement policy may have a better chance of enactment that in other recent years. 2011 could prove to be an even more significant transition point in state retirement policy than 2010 was.

Notes

1. Alicia Munnell, Jean-Pierre Aubry and Laura Quinby, *The Funding of State and Local Pensions: 2009*-2013, Center for State and Local Government Excellence, (Washington, D.C., 2010), 6.

2. See, Wilshire Consulting, *2010 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation* (Wilshire, Santa Monica, Cal., March, 2010, and the comparable 2011 report.

3. Alicia Munnell, Jean-Pierre Aub, Josh Hurwitz and Laura Quinby, *Can State and Local Pensions Muddle Thorough?* (Center for Retirement Research at Boston College, March 2011, 2-3, and references.