Vermont’s Approach to Public Employee Retirement

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Scope of Challenge

- Vermont’s pension and OPEB liabilities for Prek-12 Teachers and State Employees are large for a small state, and consistently rank among the top 10 states.
- Although VT has fully funded pension ADECs since the beginning of the current amortization period in 2008, unfunded liabilities have still grown substantially, and the funded ratios have continued to decline as the liabilities have grown faster than the assets.
- Pension costs have consumed a growing share of the state budget over time. Per the FY21 actuarial valuations, employer pension costs for FY22 were:
  - State employees: 20.7% of payroll, or $120 million.
  - Teachers: 28.4% of payroll, or $196 million.
  - Retirement costs (pension + OPEB) consume a growing share of the General Fund – from 10.5% in FY2019 to 13.1% in FY2022.
- OPEB funded on a pay-as-you-go basis without prefunding, resulting in higher unfunded liabilities on the balance sheet.
- Total unfunded retirement liabilities (Pension plus OPEB) were approximately $5.76 billion.

<table>
<thead>
<tr>
<th>Vermont Unfunded Retirement Liabilities (end of FY21) ($ millions)</th>
<th>State</th>
<th>Teachers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension Unfunded Liabilities</td>
<td>1,064.4</td>
<td>1,950.4</td>
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<tr>
<td>OPEB Unfunded Liabilities</td>
<td>1,473.1</td>
<td>1,275.6</td>
</tr>
<tr>
<td>Total Unfunded Retirement Liabilities</td>
<td>2,537.5</td>
<td>3,226.0</td>
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How Did We Get Here?

- **Impact of the Great Recession.** Pre-Great Recession, the State Employees Pension System was fully funded, and the Teachers’ Pension was over 80% funded. As of FY21, investments still had not dug out of the Great Recession actuarial hole.....

- **Changes to actuarial assumptions over time,** including lowering the assumed rate of return from 8.25% to 7.0%.

- **Demographic and experience factors,** including higher than expected retirement and net turnover experience. Both systems have also seen a major increase in beneficiaries relative to actives.

- **Experience Study in 2019 led to revised demographic and economic assumptions.** The assumed rate of return was also lowered from 7.5% to 7.0%. *From FY21 to FY22 (the first budget year impacted by the revised assumptions), employer pension costs increased by $100 million:*
  - State unfunded pension liability increased by $225.0 million and ADEC increased by $36.1 million (+43.1%).
  - Teacher unfunded pension liability increased by $378.8 million and ADEC increased by $64.1 million (+48.5%).

- **Legacy underfunding,** the State historically underfunded the teacher pension ADEC in all but four years between 1979 and 2006. Teacher OPEB also used to be paid out of the corpus of the pension fund until 2015, further adding to the unfunded liability. While these practices have stopped, they contributed about $353 million to the pension unfunded liability. And the longest liability shadow was cast because the state had not prefunded either OPEB system to any meaningful degree.
Figure 2a: VSERS ADEC vs. Actual Employer Contribution, FY2004-2021

- ADEC: Light blue bars
- Actual Contribution: Orange bars
- Funded Ratio: Red line

- Amortization Period Begins 7/1/08
- FY2004: $120,000,000
- FY2021: $67,600,000

JFO analysis based on data from actuarial valuations. Not adjusted for inflation. FY22 Actual is an estimate. FY23 ADEC based on FY21 valuation.
Recent experience studies and changes to assumptions increased pension costs year-over-year from FY 2021 to FY 2022 by $100 million. This prompted a renewed focus on the state’s retirement obligations.

- **January 2021**: State Treasurer issues report on growing pension obligations with recommendations for reducing them through changes to contributions and benefits.
- **March 2021**: House leadership unveils alternative proposals to modify contributions and benefits.
- **May 2021**: Legislature ultimately creates a Task Force with labor and legislators to come up with recommendations for action in the 2022 legislative session. Legislature also reserved $164 million of surplus FY 2021 funds to support the recommendations.
  - Additionally, the Legislature enacted reforms to the VT Pension Investment Commission to make it more independent.
  - Legislative requirement to perform experience studies at least every 3 years (instead of every 5 years).
  - Legislature created a Joint Pension Oversight Committee (6 legislators) to focus on the health and sustainability of the retirement systems on an ongoing basis in the future. This group does NOT weigh in on investment decisions or interfere with the management responsibilities of the retirement boards.
- **January 2021**: Task Force unanimously agrees to a set of recommendations to reduce pension costs and prefund OPEB
- **May 2022**: The Task Force recommendations were adopted unanimously by the Legislature, vetoed by the Governor, and the veto was then overridden unanimously.
Elements of Vermont’s Reforms

Key Theme: Reinvest “savings” from pension reforms into further shoring up the retirement systems and prefunding OPEB.

- Higher, phased-in employee contributions. Employees pay a greater share of the cost of their future benefit.
- Modest changes to COLAs for actives who are not yet eligible to retire (sharing some inflationary risk with members).
- State accelerates pay-down of retirement liabilities:
  - $200 million one-time State payment toward unfunded pension liabilities ($75M state, $125M teachers)
  - State commits additional annual payments ($15M per system per year) above the ADEC until pensions 90% funded.
  - 50% of future unrestricted General Fund budget surpluses to pension systems (25% per system).
- New pension plan created for corrections officers, with the additional cost funded by the members (4.68% of pay).
- Defined Benefit retirement security preserved for current and future hires.
- No can kicking – State maintains its closed amortization schedule that ends in 2038.
- OPEB Prefunding policy for teachers and state employees using the budgetary capacity created from the pension reforms.
- Result: Total reduction in unfunded liability of about $2 billion or 35%. Moving to prefunding OPEB alone reduced the state’s unfunded retirement liabilities by approximately $1.7 billion due to the change of discount rate.
Lessons Learned

- It takes political will to deal with retirement obligations – by all parties – and to maintain ongoing focus on the health of the retirement systems.
- The cost of inaction is high – costs steadily crowded out other priorities, hurting all stakeholders.
- Involve labor when formulating solutions and try to find agreement that is acceptable to current employees.
  - Avoid measures that could encourage mass exodus of retirements.
  - Don’t exacerbate existing recruitment and retention challenges.
  - Shifting changes only to new hires may slow liability growth in the future but does not reduce existing liability.
  - Balanced approach – give and take.
- Find opportunities to strengthen the condition of the retirement systems while also improving the long-term, fiscal health of the State- a win/win.
  - Accelerate pay-down of existing obligations to save future interest costs.
  - Prefund OPEB to take advantage of investment gains over time.
  - Improving the financial health of the benefit systems helps to guarantee economic security for plan members well into the future.