RIPEC

Public Policy Issue Brief

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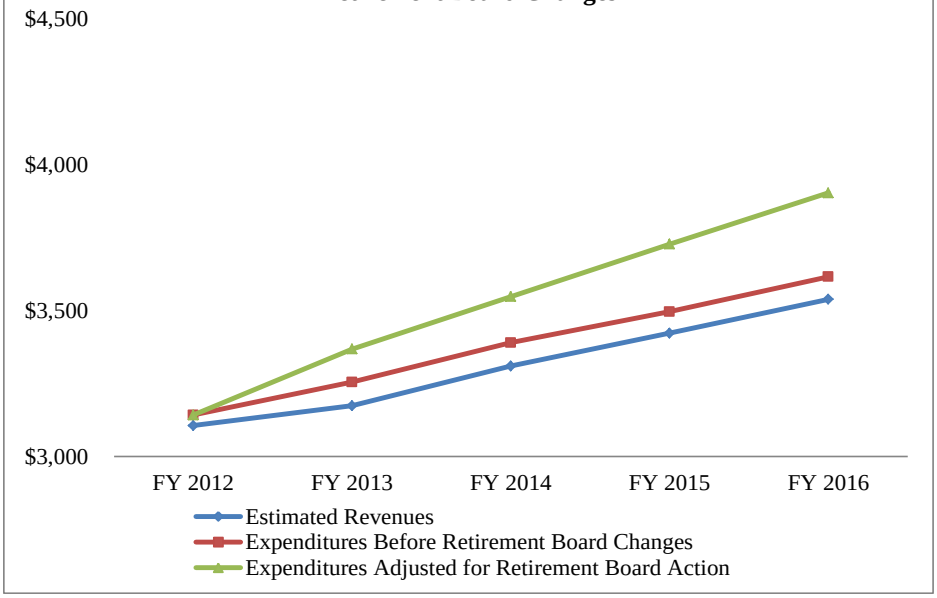
Reforming Public Sector Pensions – Executive Summary

Introduction

The current pension system is on track to consume an ever-growing share of resources, inhibiting the state's ability to make strategic investments in Rhode Island's future, realign the state's tax structure, or fix the state's infrastructure. While these costs are not the only factors contributing to the state's structural deficit, these costs have a significant impact. Chart 1 shows projected revenues and expenditures for FY 2012-FY 2016, before and after the changes made by the Retirement Board. On average, the House Fiscal Staff estimates that the actuarial adjustments will increase the projected budget gap by roughly $80 million each year between FY 2013 and FY 2016.

Chart 1
Projected General Revenues and Expenditures, Before and After Retirement Board Changes



Of note, a significant portion of pension costs are borne at the local level, exacerbating the state's already-imbalanced tax structure by putting additional pressure on the property tax to fund these liabilities. RIPEC's analysis of municipal pension obligations indicated that fully funding FY 2010 pension costs would have accounted for 14.3 percent ($290.7 million) of the statewide levy of $2,039.9 million. Based on revisions made by the Retirement Board, the local share for teacher retirement is projected to increase from $142.8 million in FY 2012 to $221.0 million in FY 2013 if no changes to the pension system are made, while communities in MERS are projected to see FY 2013 pension costs increase $32.6 million over FY 2012 pension payments of $33.1 million. Even if locally-administered plans did not increase their ARC payments, and all communities increased their levy to the cap each intervening year, local pension contributions are projected to total almost 20 percent of the statewide levy.

A consequence of funding these obligations without reform is "crowding out" spending on other programs or initiatives as pensions consume a larger share of revenues, or requiring an increase in revenues.

Significant pension liabilities have played a role in recent municipal bond rating downgrades in Rhode Island and across the country, and were cited by Moody's Investor Services in their decision to downgrade the state's outlook from stable to negative. This, in turn, increases borrowing costs for much-needed infrastructure improvements and other capital expenditures at both the state and local level. High unfunded liabilities also may inhibit business growth and development as they put additional pressure on already strained revenues. This is a particular an area of concern at the local level, where these costs are predominantly funded through property taxes, which are already some of the most onerous in the country – Rhode Island currently ranks 4th highest in the country for property tax burdens as a share of personal income.

How the state approaches the current pension challenge will affect a broad range of stakeholders, present and future. Clearly, pension reform will have an impact on current and future employees and retirees. However, there are many other stakeholders that are affected by the state's action or inaction with regard to pension reform. Individuals who rely on state and local services face potential service reductions, while taxpayers face an increase in their already-significant tax burdens. Moreover, decisions the state makes will have a lasting impact on the state's business climate as they will be reflective of the approach the state takes to governance. A proactive, principled, long-term approach will signal to businesses, taxpayers and employees alike that the state is dedicated to securing a stable – and sustainable – Rhode Island.

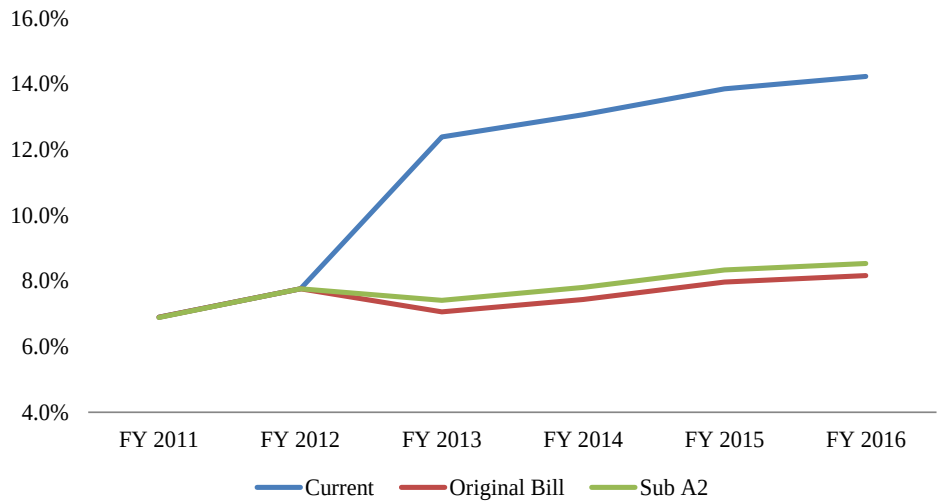
Principles to Guide Pension Reform

Pension reform is one of the most pressing issues faced by the state, at both the state and local level. The projected rate of growth is unsustainable, and even the current required contributions are out of reach for some communities. RIPEC has long-advocated for reform of the state's pension systems and believes that reform should be: sustainable, actuarially and legally sound, comprehensive, transparent and equitable. These principles are not mutually exclusive: a sustainable system is also an equitable and sound system, while an actuarially and legally sound system is also transparent.

Sustainability

State employees, teachers, state police and judges have been subject to a number of changes to their retirement plans since 2005 in an effort to rein in pension costs. Although these changes have reduced the cost to the state, they have not been enough to offset the effects of missed actuarial assumptions – particularly with regard to understated mortality rates – and poor market performance as a result of the economic downturn. Chart 2 shows the

Chart 2
ERSRI Pension Costs as a Share of Available General Revenues



projected increase in ERSRI pension costs as a share of projected available general revenue. Pension costs under the current system are projected to account for an increasingly large share of the state's general revenue budget: while the state's pension contribution accounts for almost 7.0 percent of available general revenues in FY 2011, they are expected to account for more than double that share by FY 2016 – to over 14 percent of available revenues. Under either the original or the revised legislation, pension costs are projected to increase to between 8.2 and 8.5 percent of usable revenues in FY 2016.

The state and its municipalities cannot support the pension system in its current form, and changes at the margins will not result in a sustainable system going forward. Stop-gap measures such as reamortization without comprehensive reform will only serve to ensure that the problem will be more difficult to fix in the future by increasing the overall liability without addressing the underlying issues. The proposed Act substantially reduces the unfunded liability and, thus, projected annual costs. As shown on chart 2, the state's annual payments under the proposed legislation would account for between five and six percent less than the current system in the out-years. While pension costs are still projected to increase over FY 2011 costs, the proposal puts the state on a significantly more sustainable track without forcing revenue increases or spending reductions in state and local government services.

Soundness

One of the primary factors contributing to the current status of ERSRI is the understating of the normal cost and reliance on unrealistic assumptions such as the too-high rate of return and understated mortality tables. Specifically, although the state has consistently met its ARC payments, these payments were artificially low because the assumptions understated the true cost of pension benefits. While the state has made an important first step in using more realistic assumptions, any reform must ensure pension plans are grounded in actuarially sound practices. The RIRSA includes a number of mechanisms that are designed to ensure fiscal soundness such as:

- Incorporating "trigger" mechanisms (such as the suspension of COLAs) that ensure the plans are self-correcting and are thus not subject to the political process going forward; and
- Requiring the Retirement Board to annually submit an annual report and financial statement of the plan to the governor, general treasurer, auditor general, speaker of the House of Representatives, and president of the Senate and requiring publication of a financial statement for plan members.

The changes must also be legally sound. There are nine states that explicitly prohibit public employee pension benefits from being reduced. Some of these states include New York, Illinois, Michigan and Texas. However, states that do not include such provisions in general law have also found themselves in court upon the passage of legislation that would alter retirement benefits for public employees. Colorado, Minnesota, New Hampshire and South Dakota have all seen legal challenges relating to changes in COLA provisions over the past few years. The cases, in general, center on whether COLA reductions violate protections afforded under the US Constitution – specifically the takings, contract and substantive due process clauses.

Several Rhode Island labor unions have filed suit alleging that the recent legislative changes to ERSRI are in violation of the contract and takings clauses. Specifically, that by creating ERSRI there was a contractual relationship between the state and participant. While Judge Taft-Carter dismissed the state's motion for a

summary judgment, allowing the case against the state to go forward, the decision does not explicitly prohibit the state from moving forward with pension reform. As others noted, in order to find the statute violates the contract clause of the US and Rhode Island Constitutions, the court must find that:

- The statute violates an existing contract;
- The statute substantially impairs the contract; and
- The General Assembly did not have a legitimate public purpose for enacting the statute.

While there have been no decisions in either New Hampshire or South Dakota, the courts upheld the changes in Minnesota, noting that "statutes are not contracts absent plain and unambiguous terms that show intent to contract." It further characterized the legislative amendments in question as "a minimal alteration in the calculation of future adjustments to retirees' annuities and a reasonable response to a fiscal threat that jeopardized the long-term interests of Plan members, the State and the State's taxpayers." In the justice's decision to dismiss the case in Colorado, a distinction was made between, "a retiree's contractual right to the base retirement plan benefits" and "a contractual right to a specific or particular COLA." Judge Hyatt ruled that "there is no contract right to a specific COLA formula frozen at retirement for life." This ruling appears to permit Colorado's legislature to make changes to the COLA at any time, even if that results in reduction to zero in a given fiscal year. The legality of changes to Rhode Island's pension system will, as in these cases, ultimately be settled by the Rhode Island Supreme Court.

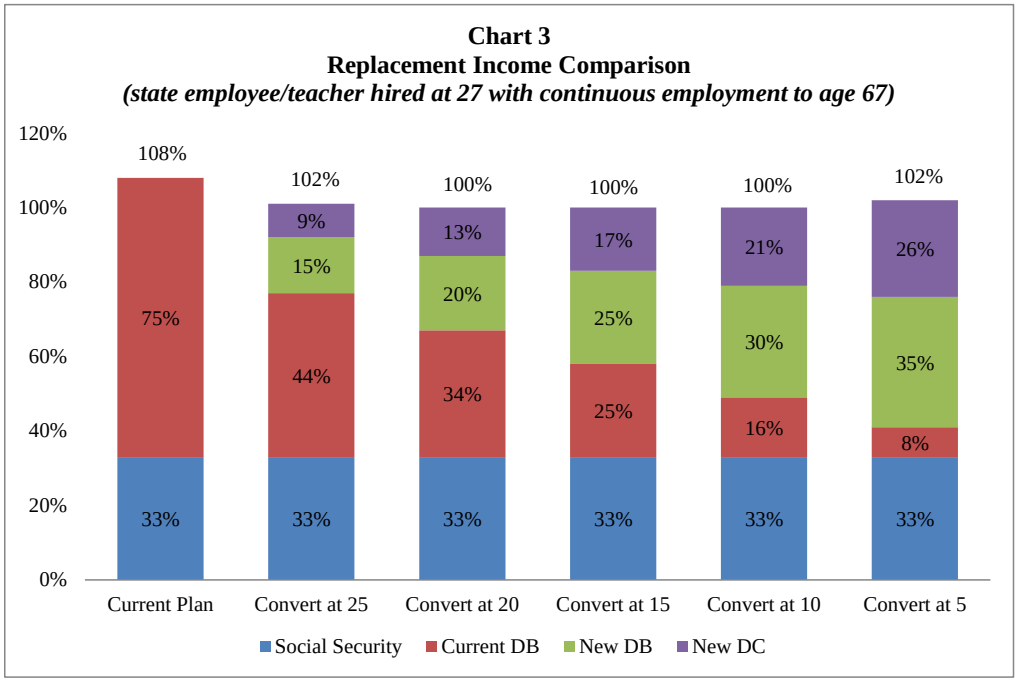
Equity

Reform should also take into account the principle of equity. Specifically, reform must equally balance the interests and needs of current employees, retirees and taxpayers. All of the reforms since 2005 have been borne by non-vested employees or current employees not eligible to retire as of a specified date. While these reforms have resulted in savings of approximately $165 million, they have not generated enough savings to ensure the fund's solvency. It is clear that change must have a broader reach in order to ensure the long-term sustainability of the fund.

If no changes are made to COLAs for current retirees, a primary cost-driver of pensions, the state would need to adopt more significant benefit reductions for active employees and new hires, without any reduction in employee contributions for active employees. A large portion of current employees' contribution goes to support the unfunded liability of current retirees. The treasurer's office estimates that approximately two-thirds of the employee contribution goes to support this unfunded liability. Without making changes to retiree benefits, current employees will continue to support these costs, while participating in a plan that is currently projected to run out of money in as few as 30 years.

Shifting to a combination DC/DB plan allows current employees to support their own retirement, through a plan that continues to grow until retirement and is portable. Based on estimates by the treasurer, employees will still see income replacement rates that are higher than the recommended targets, although the particular sources of retirement income – and risk – varies based on years of service (chart 3).

Employees closer to retirement would see the least increase in their risk (that is, the share of their benefits invested in a DC plan), while employees further away from retirement, with longer time-horizons for investment, will have an increased risk, but will still see replacement income within the recommended guidelines. Further, the hybrid aspect of the proposal offsets



the increase in the retirement age to an extent. The increase in retirement age would not prohibit an employee from retiring early, although the employee would face a delay in when they could collect without a reduction in benefits. Under a strict DB plan, the employee's retirement benefits would be set as of the date they leave state (or municipal) service; however, the portability aspect of the DC component would allow the employee to continue to contribute to their retirement, and their account would continue to accrue interest.

Another consideration is equity between the employee and the taxpayer. In contrast to the current system, where the risk is borne in its entirety by the employer, the hybrid aspect of the plan shares the risk between the employer and the employee, rather than placing the burden entirely on the taxpayer if assumptions or investment targets are not met. While revenues have recovered to an extent, it is clear that the state can ill-afford any significant increases in its tax burden, particularly at the local level. After years of declining, Rhode Island's tax burden as a share of personal income in FY 2009, the most recent year for which nationally-comparable data is available, increased to the 11th highest in the country, while the state's property tax burden as a share of personal income increased to the 4th highest in the country.

Comprehensiveness

Although achieving a sustainable level of pension contributions should be a primary goal of pension reform, pension system reform should be considered in the context of the overall human resource system. Changes such as shorter vesting periods, increased portability of benefits and a more evenly distributed benefit accrual rate may make the state's system more attractive to younger employees, who are less likely to be career employees. Similarly, changes that disproportionately impact younger or new employees may act as a deterrent to public service at a time when the state's workforce is greying. At the same time, pension systems that encourage longer terms of employment result in increased institutional knowledge and a more stable workforce. Moreover, the ability to attract and retain quality employees, particularly in hard-to-fill positions such as IT, requires a competitive and adequate compensation package. These competing interests must be taken into account when evaluating the merits of RIRSA or any other pension reform legislation.

Moreover, pension reform needs to be considered in the context of the overall budget, and the long-term goals of the state. The current pension system is a significant contributor to the state's structural budget deficit. In order to support the growing cost of retirement benefits

under the current system, the state and municipalities must either make cuts to services or increase taxes. Historic revenue declines over the past few years have resulted in state and municipal budgets that were reactionary, as opposed to forward-looking. Four years of fiscal stress have resulted in a number of significant cuts to both grants and benefits and local aid. If there is no pension reform, or reforms do not go far enough to significantly reduce the current unfunded liability, these areas of the budget will continue to face additional cuts. While revenues appear to be recovering somewhat, continued pressure on the expenditure side – such as rapidly increasing pension costs – will continue to prevent governments from making strategic investments in their future.

In addition, the plan itself must be comprehensive, both in the short and long term. In the short term, the legislation provides for immediate fiscal relief relative to the current situation. The change to COLAs, along with accompanying safeguards, and the provision for COLAs every fifth year allow for the plan to move toward a more secure funding status, while providing for adjustments based on the plan meeting its targets. The pension plan, as presented, also includes a number of elements designed to work in tandem. For example, the increase in the retirement age is balanced to an extent by the inclusion of a DC plan. Specifically, members may retire from public service prior to their retirement age but may continue to supplement their DC plan, increasing their retirement benefits upon full retirement. At the same time, the hybrid plan shares risk between the employer and employee in the long run. The increase in risk-sharing for newer employees, who have a longer time-horizon for investments, ensures the long-term sustainability of the system, while preserving already-accrued benefits for employees closer to retirement.

Transparency

Finally, pension reform must be transparent. While part of this principle requires that participants and taxpayers are well-informed of the process, the changes and the impacts, transparency also requires that the system, in its final form, be transparent. Years of understating the normal cost both increased the unfunded liability and overstated the employee's proportion of the normal cost. The proposal, as written, includes a set of self-correcting mechanisms such as the risk-adjusted COLA, and triggers to effectuate further plan changes if the plans fall below pre-determined benchmarks, as well as the requirement that both state-administered and MERS plans must develop a funding strategy in the event the plan is severely-underfunded. The legislation also includes a mandated default mechanism in the event no agreement can be reached. These triggers are removed from the political process and require increased transparency in the process for all stakeholders.

The provision that locally-administered plans conduct actuarial valuations and experience studies is an important first step to increasing transparency at the local level. A number of these plans do not conduct regular plan valuations or experience studies and, as such, may rely on inaccurate or outdated actuarial assumptions, thereby over-stating the funded status of the plans. In addition, the requirement that municipalities must submit valuations to the study commission no less frequently than once every three years ensures these plans will continue to monitor and report their status. For funds in critical status, additional notification and reporting requirements provide an additional layer of transparency.

Transparency also relies on the ability of the state to clearly communicate the changes to plan members, while providing a long enough time-horizon for employees and retirees to make

necessary adjustments. The sooner action is taken, relative to implementation, the better able the state will be to communicate the changes to members, enabling them to better respond to the changes. Delaying a decision will either shorten the time-horizon for members, or may increase the already unsustainable pension burden.

Looking Forward

The pension reform bill before the General Assembly represents a significant reform to state and local government operations and goes a long way toward reforming pension systems across Rhode Island. The suspension of COLAs for all retirees puts the system back on a sustainable path without requiring even more significant cuts for current employees, while the shift to a hybrid plan ensures that risk is shared between the state and current employees. Changes to the retirement age more accurately reflect mortality experience, and the addition of a DC plan component allows for retirees (or individuals who leave state service) to continue to accrue benefits through investment returns and individual contributions. These are fundamental changes to the cost and benefit structure for the state and MERS plans. However, only time will tell if these changes prove to be enough in the long-term.

At the same time, the ability of municipalities to support local pension obligations, both for plans in MERS and for locally-administered plans, represents a significant challenge for Rhode Island municipalities. As with the state plans, the question is whether the assumptions included in the legislation will hold up in the future, or whether there will be a need for future revisions. As RIPEC has noted, the status of locally-administered plans is of great concern. The legislation provides a positive starting point with regard to the requirement that actuarial valuations and experience studies be performed for these plans, as this will provide a clearer picture of the nature of the problem for locally-administered plans.

Principles of Pension Reform

***Sustainable**: reforms should be comprehensive enough to prevent the need for future revisions, and should ensure that taxpayers and employees are able to support the system without the need for increases in taxes or cuts to services; **Sound**: plan funding should be grounded in actuarially-sound practices so the funding of obligations is sufficient, and changes should be able to pass legal muster; **Equitable**: changes to the system should not unduly affect one class of employees over another, they should preserve what employees have earned, and risk should be borne by both the employer and employee; **Comprehensive**: pension reforms should not be undertaken simply as a cost-saving measure, but should be considered in the context of the overall budget and as part of a personnel restructuring process; and **Transparent**: changes and underlying assumptions should be clearly understandable to plan members and taxpayers, as should the need for plan changes..*

The concern is that these studies will show a much deeper problem than currently identified. For example, half of the plans currently use an assumed rate of return over 8.0 percent, while the average assumption across the plans is 7.8 percent; higher than the state's revised target, which is higher than recent experience. Similarly, communities that have not updated their mortality assumptions will face the same set of circumstances as the state. As noted in RIPEC's report on local pension and OPEB liabilities, 18 plans failed to meet 100 percent of their ARC payment in FY 2010 and to do so would, in many cases, would require a substantial, and potentially unaffordable, increase in funding. Of note, eight of the 18 plans that did not meet their full FY 2010 ARC are designated as distressed or fiscally stressed communities by the state.

If the locally-administered plans do, in fact, face the same challenges – or worse – than the state is currently facing, which RIPEC believes is

likely the case, the issue of pension reform for locally-administered plans will ultimately be returned to the General Assembly for consideration and action. In this event, the following issues should be considered:

- Can local governments implement action plans, similar to the one the state is considering?
- Will local governments have the needed flexibility and means to accomplish fundamental changes, particularly with regard to requirements contained in the current collective bargaining statutes including binding arbitration?
- Do local governments have the ability to take unilateral action if negotiated settlements cannot be reached?

How state and local governments raise and spend money reflect policy choices. Currently, the state has a choice – comprehensively reform pensions or face significant tax hikes or cuts to services. Failing to act on the pension issue will force additional spending reductions after years of difficult decisions. This is particularly true at the local level. Cuts to state aid of over $200 million in the past few fiscal years have placed increasing fiscal stress on communities that already face some of the highest property tax burdens in the country (4th highest as a share of personal income). While municipalities have absorbed those cuts, the projected increase in pension liabilities for many communities will force even further cuts to services or property tax hikes at a time when the state cannot afford to increase the resident tax burden. More importantly, the affordability and sustainability of the pension system will impact state and local flexibility with regard to responding to economic uncertainty and demand for government services.

The pension system, in its current form, is unsustainable. Marginal changes, or changes that simply push out the problem into the future such as reamortization or increasing the assumed rate of return, without comprehensive reform, will only serve to ensure that the problem will be more difficult to fix in the future. The pension reform legislation before the General Assembly will have a fundamental impact on the Rhode Island of the future. The legislation provides an opportunity for the state to comprehensively reform the state's human resource system into one that is responsive to the needs of the current workforce, while ensuring long-term fiscal sustainability. RIPEC believes the General Assembly needs to take action and approve the proposed reform legislation.