

## No easy fix to pension pains

### Fiscal pressure mounts to rework state retirement systems

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This edition of *Firstline Midwest* is Part 1 of a two-part series on state public retirement systems. Part 1 focuses on state pension plans and recent legislative changes to them. Part 2 will focus on issues related to retiree health care and other non-pension benefits.

The Midwestern Office of the Council of State Governments supports several groups of state officials, including the Midwestern Governors Association and the Midwestern Legislative Conference, an association of all legislators in the region's 11 states. The Canadian provinces of Manitoba, Ontario and Saskatchewan are affiliate members of the MLC.

Michigan lawmakers say they found a way to save \$3.1 billion over 10 years, but the path to legislative approval wasn't easy. And when the changes to the retirement system for teachers were finally signed into law in May, one teachers union called them an "attack on the women and men who educate our children."

In Illinois, state leaders estimate that a bill signed into law in April will save taxpayers \$200 billion over a 35-year period. Gov. Pat Quinn's office lauded the measure as "historic public pension reform"; the Illinois Teachers Federation countered by saying "the new law will do grave and long-lasting harm."

They are very different perspectives on an issue that is requiring more and more attention from policymakers: the future of public employee retirement systems. Few policies have such important long-term implications for states and the people who work for them. On the one hand, there is the need to ensure the systems are fiscally sustainable. On the other, there is the need to attract good workers and to provide income security for them in their retirement years.

Recent events and trends have made balancing these priorities a challenge: the budget crisis, stock market volatility, and heightened concerns about the cost of retiree health care. In some states, too, these problems have been made

worse by past policy actions — or inaction.

As the Pew Center on the States notes, some pension systems were severely underfunded even prior to the national recession. On top of that, most states have done little to meet their future liabilities related to retiree health care.

The path to fiscal sustainability comes with costs — to states, future public employees, current workers, or some combination of the three. Under the new Michigan law, for example, teachers

must contribute an additional 3 percent of their salaries to a newly established retiree health care trust fund. In addition, all new teacher hires will be placed in a "hybrid" pension plan: part defined contribution and part defined benefit.

Illinois' new law will affect newly hired teachers and many newly hired state employees. The change that got the most public attention was a raising of the retirement age from 60 to 67. Will this change impact Illinois' ability to attract qualified teachers and workers? At least this year, any such concerns were outweighed by unease about fiscal sustainability.

Other states have also decided a rebalancing is in order. Some of the recent actions taken by Midwestern states will be highlighted in the next two editions of *Firstline Midwest*. Inside this month's edition, we focus on recent legislative changes to public pension systems. Next month, we will examine issues related to retiree health care and other non-pension benefits. ★

#### Ratio of active employees to retired employees in state, local retirement systems\*

Year	Ratio
2008	2:1
2006	2.14:1
2004	2.24:1
2002	2.38:1
2000	2.52:1
1996	2.89:1

\* Findings based on survey of more than 80 public employee retirement systems in U.S.  
Source: Wisconsin Legislative Council

# Pension changes reflect long-term fiscal concerns

In part, the Pew study (titled “The Trillion Dollar Gap”) compares and contrasts the health of different state public retirement systems. Differences in the Midwest are sometimes striking.

For example, Pew found, **Wisconsin’s** \$77 billion long-term pension liabilities were almost completely funded as of the end of fiscal year 2008. In neighboring **Illinois**, a little more than half of the \$119 billion in liabilities was funded.

As of the end of FY 2008 (before pension fund investments were walloped by a downturn in the stock market), most states in the Midwest were funding their pension systems at or above 80 percent, the threshold generally used to indicate whether enough money is being set aside to meet current and future benefit obligations.

“The make or break factor for keeping a retirement system well funded is to pay the actuarially required contribution consistently,” the Pew study notes. In some states, statutory or constitutional language mandates that this level of contribution be made.

Other states have issued pension obligation bonds. In 2003, for example, Wisconsin issued these bonds, allowing the state to pay off its unfunded accrued pension liabilities. Pew notes another unique aspect of Wisconsin’s system: Retirees are not guaranteed a cost-of-living increase; instead, annuity adjustments depend on investment returns as well as the funding needs of the retirement system.

The two systems in the worst shape in the Midwest as of the end of FY 2008 (at least according to pension funding levels) were Illinois (54 percent) and **Kansas** (59 percent). Not surprisingly, then, those two states have adopted comprehensive plans to make their systems more fiscally sustainable.

In both states, lawmakers have created two-tiered benefit structures: one for current employees, a second for new hires.

Kansas’ pension changes were made in 2007 with passage of SB 362. The two-tiered structure created by the bill has several measures designed to improve the system’s long-term fiscal outlook. They include:

- Two different contribution rates, with the rate for new hires set two percentage points higher.
- Stricter eligibility rules for when new hires can retire with full benefits. For example, the “rule of 85” allowing full benefits for anyone whose age and years of service equal 85 was eliminated. For new hires, normal retirement is age 60 with 30 years of service.
- A change in how a new hire’s retirement benefit will be calculated. It is based on the worker’s average salary over the last five years of employment; for current employees, the benefit is calculated based on the last three years served. In addition, SB 362 included a compensation cap of 7.5 percent on pay increases in the five years that determine benefits.
- A stipulation that the employer contribute at an “actuarially determined” rate and that future cost increases be shared equally by employers and employees.

The latest changes to Illinois’ pension system were made when Gov. Quinn signed SB 1946 into law earlier this year. It takes effect in 2011.

Under the new law, the normal retirement age for new hires will be 67. In addition, a maximum pensionable salary was put in place (\$106,800), the final-average-salary formula was changed (it is now based on the highest average over an eight-year period, rather than four years), and the vesting period was raised to 10 years. Another measure eliminates retirees’ annual cost-of-living rate increase of 3 percent; in its place will be a yearly increase equal to half the change in the consumer price index or 3 percent, whichever percentage is lower. SB 1946 also bars “double dipping,” when a public employee is receiving a pension while drawing a salary from a different public retirement system.

## Rise in unfunded liabilities will likely continue

Though Pew’s numbers showed Illinois and Kansas as having the region’s most severe problems, state retirement systems across the nation have taken a blow in recent years. According to an April report by the Center for Retirement Research at Boston College, in 2000, the assets in state pension plans amounted to 103 percent of liabilities — thanks in part to investment gains in the stock market. By 2009, the center estimates, pension funding levels had fallen to 78 percent. It projects that by 2013, the average could dip to as low as 66 percent.

Every state has its own set of ratios and estimates. But based on the actions taken in recent years, policymakers clearly saw reason for concern in their own states.

One common approach has been to increase contribution rates, both for employers and employees. According to the National Association of State Retirement Administrators, as of May, **Iowa** and **Minnesota** were among the states that had raised contribution rates in 2010. (Other states have done so in recent years as well.)

The Iowa and Minnesota legislatures adopted other changes to their state pension systems as well.

For most public employees, Iowa’s HF 2518 revises the final-average-salary period, making it five years instead of three, and increases the vesting period (the amount of time someone needs to work before receiving all of the pension contributions made by the employer) from

four years to seven. Also in Iowa, legislators agreed to make a general fund appropriation of \$5 million per year (beginning in 2013) until the state’s Peace Officers Retirement Fund reaches a funding ratio of 85 percent. Finally, under HF 2518, individuals who leave their jobs prior to normal retirement age will face a greater reduction in retirement benefits.

In Minnesota, cost-of-living adjustments for existing retirees were reduced until pension funding levels reach 90 percent, and vesting periods were increased, from three years to five. Also under HF 3281/SF 2918, the state merged the administrative functions of two different public pension plans.

The **South Dakota** Legislature, meanwhile, passed two different measures designed to improve the health of the state’s public retirement system. SB 20 eliminates current retirees’ guarantee of an annual cost-of-living increase of 3.1 percent. Instead, the yearly adjustment will vary depending on the health

### Projections of unfunded liabilities in state and local pension plans

Year	\$ amount
2013 (projection)	\$1.2 trillion
2011 (projection)	\$973 billion
2009 (projection)	\$728 billion
2007	\$373 billion
2005	\$355 billion
2003	\$245 billion

*Source: Center for Retirement Research at Boston College*

# Overview of retirement systems and legislative options

A vast majority of government workers in the Midwest are enrolled in traditional defined-benefit plans. As a result, many of the ideas to improve the long-term fiscal outlook of public retirement systems cut across state lines.

Some of the strategies that have been implemented by states are listed in this article. In addition, to provide a general overview of the systems, recent findings of the Wisconsin Legislative Council are included. Every two years, the council issues a report summarizing the structure of more than 80 of the nation's state and local retirement systems. The most recent version was released in December 2009 and updated in May; it reviewed the retirement systems in place as of 2008.

## **Strategy: Raise employee and/or employer contribution rates**

**Council findings on employee contribution rates** — In 2008, 30 of the 87 plans set contribution rates for employees below 5 percent and 46 set rates above 5 percent. The rate varies in a handful of plans, usually based on age and employee classification.

## **Strategy: Raise retirement age/change “normal retirement” formula**

**Council findings on “normal retirement” provisions** — As of 2008, nearly every state retirement plan allowed “normal retirement” (leaving the state workforce with full benefits)

for individuals who are 62 years old and who have a certain number of years of service. In addition, employees 55 or older often are eligible for normal retirement if they have worked a certain number of years (most commonly 30 years, but sometimes as high as 35 and as low as 20).

Some plans, too, offer full retirement benefits to workers whose age plus years of service equal a certain number. For example, a 55-year-old with 30 years of experience is eligible for normal retirement if his or her plan offers a “rule of 85.” In 2008, “rule of 85” provisions were in place in one or more of the public retirement systems in Illinois, Indiana, Kansas, Nebraska, North Dakota and South Dakota. Iowa had a “rule of 88”; Michigan and Minnesota a “rule of 90.”

## **Strategy: Lengthen vesting period**

**Council findings on vesting periods** — In 2008, the vesting period (defined in the Wisconsin study as the minimum service requirement of an employee before he or she is guaranteed some pension benefits) in state retirement plans was most often five years or less.

In Wisconsin, no vesting period was required of employees; on the flip side, in 2008, plans in Indiana, Kansas and Michigan had 10-year vesting periods.

## **Strategy: Increase number of years in which “final average salary” is calculated**

**Council findings on “final average salary” calculations** — The retirement benefit for a state employee is based in part on his or her final average salary. In 2008, this was usually calculated in one of two ways: two-thirds of the plans used a three-year average (often the highest three years of salary for the employee), while 21 percent used a five-year average.

## **Strategy: Reduce the cost-of-living adjustment for retirees**

**Council findings on cost-of-living adjustments** — In 2008, 35 plans tied cost-of-living adjustments to the consumer price index and 26 provided an automatic percentage increase. Nineteen of the plans left the decision of cost-of-living adjustments to the legislature or a decision-making board, and five based the adjustment on investment surpluses in the retirement fund. In the Midwest, most retirement plans that provided an automatic percentage increase (as of 2008) set it at 3 percent.

**Other strategies:** Two other changes to benefit structures that lawmakers might consider are: 1) modifying the “multiplier,” the percentage that, along with final average salary and years of service, is used to calculate an individual worker's retirement annuity; and 2) setting new limits on the pension benefit of individual retirees.

of the retirement system, as determined by its pension funding level. Under a separate bill, SB 18, the Legislature put new limits on retirement pay for “retire rehire” employees — those who retire and then return to work.

## Alternatives to defined-benefit plans

Though it has been a tumultuous period for state public retirement systems, policymakers have thus far largely decided to keep intact these systems' basic structure: that of being defined benefit plans, which rely on employee and employer contributions and investment earnings and which place the investment risk on states (the retired worker's benefit is defined, the state's return on investment is not).

Only a handful of states veer away from the traditional defined-benefit model, with MICHIGAN being one notable example in the Midwest.

Since 1997, most new state employees in Michigan have been automatically enrolled in a defined contribution plan: each employee has his or her own retirement account, thus bearing the investment risk. Until this year,

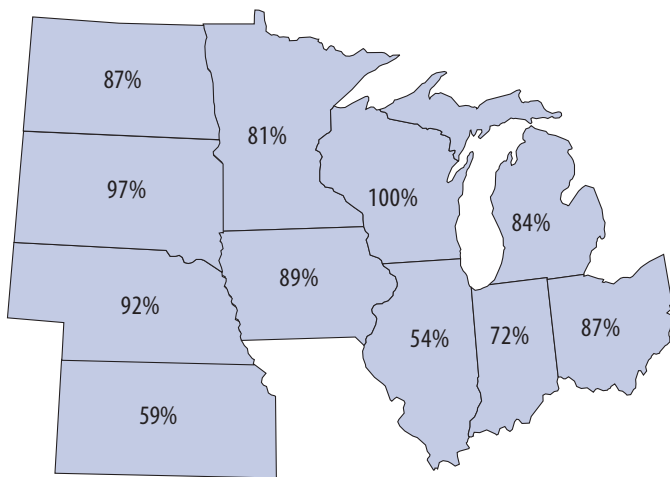
a defined-benefit plan was used for teachers in Michigan. However, with passage of SB 1227, newly hired teachers will be placed in a new hybrid plan: part defined benefit, part defined contribution.

According to the National Conference of State Legislatures, INDIANA has a hybrid plan for state employees and teachers, with employee contributions going to the defined-contribution portion and the employer contribution dedicated to the defined-benefit portion. OHIO also offers a hybrid plan.

NEBRASKA uses a “cash balance” plan: Nebraska state employees each have their own retirement account and are guaranteed a certain rate of return on investments (5 percent); upon their retirement, workers can set up an annuity or get a lump-sum payment equal to the amount of money in their retirement account.

At one time, Nebraska state employees were enrolled in a defined contribution plan and teachers in a defined-benefit plan. The defined-contribution plan was scrapped after a state analysis showed that enrollees “were ending up with skimpier pension payments than the state's teachers,” according to the Pew Center on the States. ★

## Pension funding levels in the Midwest (as of the end of fiscal year 2008)



\* Ohio's funding level is for the end of fiscal year 2007. The pension funding level is based on the difference between a state's pension assets and liabilities.

Source: Pew Center on the States

## SOURCE GUIDE

For information on state retirement systems for public employees, visit the following websites:

Center for Retirement Research at Boston College  
<http://crr.bc.edu>

Center for State & Local Government Excellence  
[www.slge.org](http://www.slge.org)

National Association of State Retirement Administrators  
[www.nasra.org](http://www.nasra.org)

National Conference on Public Employee Retirement Systems  
[www.ncpers.org](http://www.ncpers.org)

Pew Center on the States ~ "The Trillion Dollar Gap"  
[www.pewcenteronthestates.org](http://www.pewcenteronthestates.org)

U.S. Government Accounting Office  
[www.gao.gov/new.items/d08223.pdf](http://www.gao.gov/new.items/d08223.pdf)  
[www.gao.gov/new.items/d071156.pdf](http://www.gao.gov/new.items/d071156.pdf)

Wisconsin Legislative Council ~ "2008 Comparative Study of Major Public Employee Retirement Systems"  
[www.legis.state.wi.us/lc/publications](http://www.legis.state.wi.us/lc/publications)

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