Pension Reform

Principles:

Any reforms to pensions should consider the long-term solvency of a plan and protect the promised benefits for employees already in the system. The benefits in a public employee retirement system should be sustainable, secure and affordable:

- Provide retirement security for all members (current and future) and retirees.
- Manage and mitigate taxpayer and pension system exposure to financial risk and market risk.
- Reduce long-term costs for employers or taxpayers as well as employees.
- Stabilize contribution rates.
- Ensure the ability to recruit employees.
- Improve governance & transparency.

The best pension reforms emerge from collaborative efforts involving a broad cross-section of stakeholders in a process that examines a system's flaws, explores and analyzes all possible methods of reform, and achieves consensus on a package that meets these principles.

Recommendations:

- Reduce the risk of the plan assets and adopt a lower assumed rate of return, both to reduce taxpayer risks in the evolving market volatility for institutional investing as well as to have more realistic expectations about returns on assets.
- Adopt a new discount rate practice that bases the discount rate on a measure of the risk of plan liabilities (since the discount rate is intended to value liabilities) instead of being based on a measure of the risk of plan assets (the status quo approach).[1]
- Establish shorter pension debt payment schedules, which will reduce long-term costs through the reduction of unnecessary and expensive interest on unfunded liabilities.
- Explore optional, alternative retirement plans for newly hired teachers that offer portability, balance risk and better address the retirement security needs for short-term employees, such as hybrid plans, cash balance pensions, and defined contribution retirement plans.
- Replace retiree health benefits with up-front, annual contributions to employees' Health Savings Accounts.

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Facts:

Georgia was ahead of the reform curve in 2008 when it created a hybrid pension plan for all new state employees with an option for existing employees to participate.

Relative to other states, Georgia is in a better than average position, yet still has a great need for improvement.[2]

[1] http://reason.org/files/pension_discount_rates_best_practices.pdf
[2] Special thanks to the Reason Foundation for their assistance with this chapter.

	Promised Retirement Benefits	Unfunded Liability	Funded Ratio
Georgia Employees' Retirement System	$17,829,220,000	$4,348,001,000	75.6%
Georgia Teachers Retirement System	$100,291,641,000	$21,502,704,000	78.56%
Georgia Retiree Health Benefits	$12,842,329,852	$11,257,201,447	12.3%

Source: State actuarial valuations, data as of fiscal year end 2019

Table 1.1

	Assumed Rate of Return	Average Actual Return 2005-2019	Average Actual Return 2001-2019
Georgia Employees' Retirement System	7.30%	6.66%	5.79%
Georgia Teachers Retirement System	7.25%	7.03%	6.09%

Source: State actuarial valuations and CAFRs, data as of fiscal year end 2019

Table 1.2

Overview

There has been an alarming rate of growth in recent years in the required, taxpayer-funded employer contributions to Georgia's two major retirement systems, the Employees' Retirement System (ERS) and the Teachers Retirement System (TRS). This growth is expected to continue.

Required employer contributions to the "old plan" component of ERS grew from 10.41% of compensation in 2011 to 20.03% in 2019. TRS-required employer contributions grew from 9.28% of compensation in 2009 to 20.90% in 2019. These rates are much greater than in the private sector, even when Social Security is considered. Compared to other states' plans, while not extravagant, Georgia's ERS and TRS are generous in terms of overall benefits provided relative to required employee contributions.

Contrary to widespread belief, defined benefit pension plans are designed to be *pre-funded* and should not require a steady influx of new participants to remain solvent. In other words, they should not require contributions from current workers to fund current retiree pension benefits. While an employee is working and accruing benefits, the plan should receive enough contributions from both employers and employees to cover all future retirement benefits promised. This differs from Social Security, where current workers are taxed to pay the benefits of current retirees (e.g., a "pay-as-you-go" system). When a defined benefit plan participant retires, the plan should have the total amount needed to provide the lifetime benefits promised to a public worker.

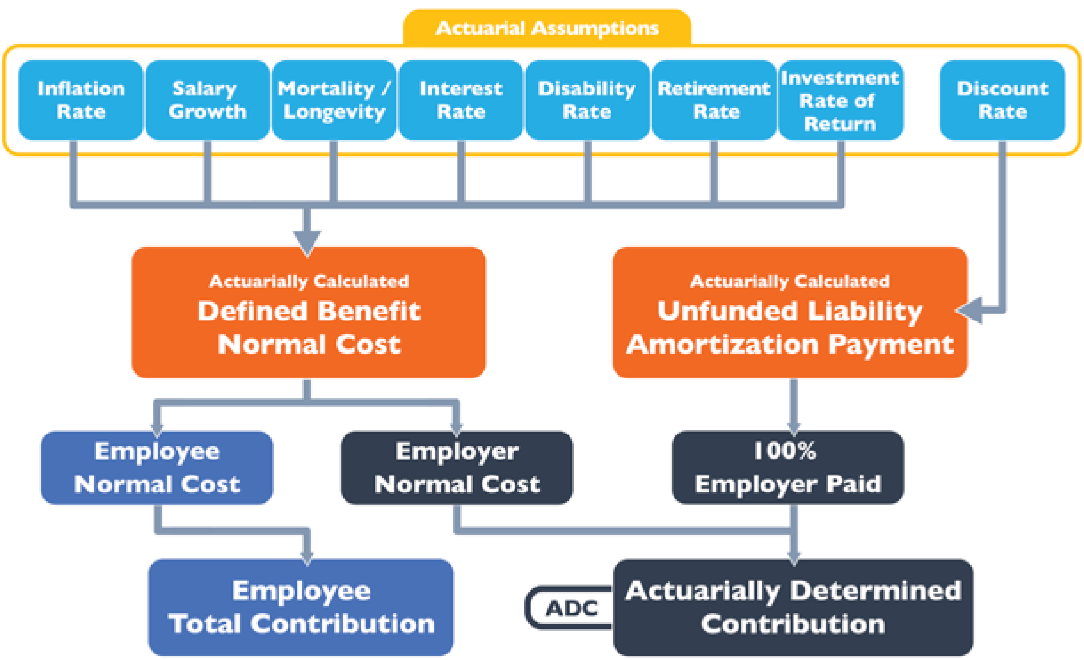
Hence, the amount of employer and employee contributions required each year to pre-fund promised future benefits is a critical element of pension financing and is based on two primary components:

- The annual cost to pre-fund promised pension benefits, known as *normal cost*; and
- The cost to amortize pension debt – known as unfunded liability amortization payments – if normal cost is miscalculated, employers didn't make their required annual contributions in previous years, or investment returns underperform.

Both ERS and TRS have relied on actuarial valuations to determine annual contributions. These valuations are based upon a set of assumptions – assumptions that can differ from actual plan experience. For example, for much of the past two decades ERS and TRS have assumed their assets would return an average of 7.5% over time. Since 2001, however, returns for the two plans have been closer to 6%. This is not just because of the 2008 financial crisis. Several years saw more than 10% returns, but there were also many years with less than 5% returns, and more than one year with negative returns.

Before these plans fully recovered from a recession over a decade ago, they encountered yet another significant challenge: Returns in 2020 are anticipated to be well below the systems' assumptions, as a result of the economic disruption caused by the COVID-19 pandemic.

The result of having overly aggressive or unrealistic actuarial assumptions is that current taxpayers and public workers end up paying less than they should to save enough for the actual cost of the retirement benefits being accrued by existing state employees and teachers. This creates unfunded liabilities that are amortized over extended periods of time, meaning future taxpayers bear the burden of paying off this debt.



Nationwide, and in Georgia, we have observed a massive transfer of debt to the next generation – many whom have not yet been born. But this is not just a problem for the future; today's taxpayers are already having to bear the costs of previous generations. For example, unfunded liability amortization payments – payments on pension debt – currently account for more than half of what taxpayers are paying into the TRS plan.[3]

Accounting rules effective since July 1, 2014, for ERS and TRS significantly changed the method of accounting for deferred compensation for government employees. While the Other Post-Employment Benefits (OPEB) rules continue to evolve, the new pension rules are set and have correctly revealed previously unrecognized obligations, significantly reducing the funded status of all governmental plans,

[3] For example, see page 24 of the 2015 TRS CAFR, employer normal cost is 6.14% and the amortization payment is 7.01%.

including ERS and TRS. If the OPEB rules ultimately adopted are in line with the pension rules, then the combined pension/OPEB unfunded liability for ERS and TRS will be substantial.

In 2008, the State of Georgia Merit System, a public human resources consulting office, contracted with Mercer Human Resource Consulting to evaluate state employees' satisfaction with Georgia's total compensation package. The study found that public workers were dissatisfied with salary levels. They thought pay was below market rates and poorly reflective of performance.

When it comes to retirement planning and security teachers are being systematically disadvantaged in the early years of their careers.

Employees under age 30 earning less than $35,000 annually (the majority of Georgia's public workforce in 2008) were particularly dissatisfied. They valued current salary higher than deferred benefits, and were concerned about the lack of portability of their defined benefit plan.

In response to the study, then-Governor Sonny Perdue allocated $400 million of the 2008 budget to public employee wage increases. Subsequently, the Georgia General Assembly passed a bill that established a hybrid pension plan for ERS and closed the traditional defined benefit plan for new hires.[4] All employees hired after January 1, 2009, participate in the hybrid plan, while current participants in ERS plan may choose to join the hybrid plan at any time.[5]

This approach also makes sense for teachers

The range of options possible for remaking TRS include defined contribution plans, modifications to the current defined benefit pension plan, hybrid retirement plans that combine features of the first two, cash balance plans and even combinations of these different types. The important principle to adopt first is that TRS should be modified to be more in line with plans of other employers and to be fairer to teachers and taxpayers.

Challenges with the Teachers Retirement System

TRS represents a significant cost to taxpayers, but it is an important part of teachers' compensation and benefits package. The current system is typical of government-teacher pension plans set up many years ago and serves many teachers well (especially those who put in more than 30 or 40 years). With so many situations where it works poorly in today's world, however, policymakers should consider expanding alternative plans for new workers who are less likely to remain for their entire career.

The majority of Georgia's teachers are hired at a young age, often right out of college. According to Bellwether Education Partners:

> Today's systems shortchange the vast number of teachers who may change jobs and teach in a different state or a school district covered by a different pension plan, as well as those who leave teaching to work in another sector. When it comes to retirement planning and security teachers are being systematically disadvantaged in the early years of their careers, a critical time to start building retirement savings. To put it in simple terms, teachers can lose more than half of their pension wealth just for moving *one* time; if teachers move multiple times – if, for example, their

[4] Center for Retirement Research at Boston College, http://crr.bc.edu/wp-content/uploads/2011/09/Georgia-2.pdf
[5] As of 2018, 81 members had transferred into the hybrid plan.

spouse was in the military – the losses would be even greater.

For this group of employees there are several issues that make TRS uncompetitive:

- **Vesting**: Any employee who works less than 10 years forfeits all employer-paid benefits. (They keep their own contributions, plus interest.) Consider a prospective employer telling you, “We have a great retirement plan, unless you leave before 10 years, in which case you get nothing from us.” This approach was common 30-40 years ago, but today it is uncompetitive with the private sector and many public sector employers.
- **Rate of benefit accruals**: Like other traditional pension plans, employees hired at young ages see the value of their benefit under TRS grows slowly for the first 10 to 15 years, then the value growth accelerates. As they approach retirement the value climbs dramatically. Employees who stay until retirement are rewarded well (often referred to as backloading). This approach, common many years ago, does not fit today’s workforce.
- **The flip side of "backloading**:" Because of the significant backloading of benefits under TRS, a teacher who has put in 20 years stands to lose a lot if he or she wants or needs to change jobs – for example, relocating to another state due to a spouse’s employment or other family issues. An employee in this situation has invested 20 years, in part to get the benefits of the large ramp-up that happens right before retirement, and will lose out due to circumstances beyond his or her control. This can create “job lock,” where an employee who isn’t happy (or perhaps effective) in the job can’t afford to walk away from the big payoff that occurs in the last few years.

In 2015, Georgia State Senator Hunter Hill proposed legislation to place new teachers in a hybrid defined benefit/defined contribution retirement plan. It garnered significant legislative support but was not adopted. Several smaller pension reform bills met a similar fate in the 2020 session.[6] This is because Georgia law places a high hurdle in front of potential structural changes to pension systems. A legislator must submit a full reform proposal, which then needs separate legislative approval of an actuarial analysis of that proposal. Hill’s legislation failed to receive that approval. A reform proposal that makes it through the actuarial analysis phase must then be adopted as is; amendments trigger a need for a separate actuarial analysis.

Pension Reform in Other States

Since 2009, almost every state has implemented some reform of defined benefit pension systems, largely in response to the economic downturn and a growing awareness of the financial risks that governments and taxpayers are exposed to regarding retiree benefit guarantees. Most modifications were not fundamental shifts away from defined-benefit pension systems, however. Common changes include changes to pension benefit formulas; revisions to cost-of-living-adjustment; increases in retirement ages and years-of-service requirements; increases in employee contribution rates, and the addition of optional defined contribution plans.

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At least 15 states have shifted at least one of their state pension systems to a mandatory defined contribution style plan, typically through a standalone defined contribution plan or hybrid defined benefit/defined contribution plan. Oregon, Virginia, Tennessee, Rhode Island and Utah are among the states that, like Georgia, shifted new civilian employees to a hybrid plan. Others, like Kansas and

[6] https://reason.org/commentary/proposed-reforms-to-georgias-teacher-pension-system-missed-the-mark/

Kentucky, have adopted cash balance plans – a type of defined benefit plan that borrows many characteristics from defined contribution plans – for new hires.

One of the more robust recent hybrid-style reforms comes from Arizona. In February 2016, Arizona policymakers overwhelmingly approved comprehensive, bipartisan pension reform legislation designed to put the state's beleaguered public safety pension system on a path to financial solvency, reduce taxpayer exposure to financial risk by more than half, reduce long-term costs for employers and employees, and offer public safety personnel a choice between a hybrid plan or a portable defined contribution plan.[7]

Even more notable than the reform itself is the process used to achieve stakeholder consensus, avoiding the adversarial dynamic of pension reform policy debates that typically pit employers/taxpayers against employees and labor interests. The legislation was the product of a yearlong dialogue and negotiation involving policymakers, unions, municipalities and the pension experts at the libertarian Reason Foundation. Ultimately, it garnered extensive support from public safety unions and many other stakeholders in the government and business community.

Four states have reforms that go further, placing some categories of new hires into mandatory defined contribution plans. Michigan was the first to enact this reform in 1996, followed by Alaska (2005), Arizona (2013; elected officials and judges only) and Oklahoma (2014). Michigan's state employee plan transitioned to a defined contribution (DC) plan in 1997. Since then, new state employees have received a 4% employer contribution plus a dollar-for-dollar match up to 3% of pay deferred by the employee.[8] In Alaska, state and school employees hired after June 30, 2006, participate in a DC plan. The employer makes an 8% (of compensation) contribution. State employees contribute 5% and school employees contribute 7%.[9]

Other studies and opinions

Manhattan Institute:

> Job mobility causes most teachers to be worse off under a traditional DB (defined benefits) pension arrangement than they would be under a DC (defined contribution) or cash balance arrangement that transferred some compensation from the DB plan to current pay on a cost-neutral basis.
>
> ... only about 28% of American public school teachers remain in the profession for even 20 years. The overwhelming majority separate from service well before reaching the retirement thresholds in any public retirement system.
>
> [D]istricts should jettison their current approach to retirement benefits, in which teachers accrue relatively meager benefits through much of their careers, and then abruptly become eligible for much more as they near retirement age. In its place, districts should adopt retirement systems where benefits accrue smoothly, year after year, without sudden, arbitrary jumps late in a teacher’s working life. This would allow talented people to teach for part of their career, or teach in more than one district, without harming their retirement security. It would also end an unfair practice that places the majority of teachers on an insecure retirement savings path in order to support more generous pensions for the minority who work a full career in one system.[10]

[7] For details on the Arizona reform, see here: http://reason.org/news/show/az-public-safety-pension-reform
[8] http://reason.org/news/show/pension-reform-case-study-michigan
[9] “Did Pension Reform Improve the Sustainability of Pension Plans? Evidence from a Counterfactual Analysis of Michigan and Alaska,” Reason Foundation, 2016, http://bit.ly/1NkLxu9
[10] “Better Pay, Fairer Pensions: Reforming Teacher Compensation,” Center for State and Local Leadership at the Manhattan Institute, September 2013, http://www.manhattan-institute.org/html/cr_79.htm#.Uzxs49z21Qo

National Council on Teacher Quality:

> Many assume that defined benefit pension plans are a clear win for teachers. The reality is that these costly and inflexible models are out of sync with the realities of the modern workforce and built on a model that assumes low mobility and career stability. They help to put public education at a competitive disadvantage with other professions.[11]

Urban Institute:

> When it comes to investing additional retirement savings, a plurality of teachers favor defined contribution plans which offer more portability and choice, but more risk than traditional defined benefit plans. Perhaps unsurprisingly, all else equal, teachers newer to the profession are more likely than veteran teachers to favor a defined contribution structure.[12]

The Economist:

> States should accelerate the shift to defined-contribution pension schemes, where what you get out depends on what you put in. (These are the norm in the private sector.) Benefits already accrued should be honored, but future accruals should be curtailed, where legally possible. The earlier you grapple with the problem, the easier it will be to fix. Nebraska, which stopped offering final-salary pensions to new hires in 1967, is sitting pretty.[13]

The Commission on American Workforce Skills, chaired by former University of Georgia President Charles B. Knapp:[14]

> Many of our teachers are superb. But we have for a long time gotten better teachers then we deserved because of the limited opportunities for women and minorities in our workforce. Those opportunities are far wider now, and we are left with the reality that we are now recruiting more of our teachers from the bottom third of the high school students going to college than is wise. To succeed, we must recruit many more from the top third.
>
> To get this group requires us, first, to change the shape of teacher compensation, which is currently backloaded, in the sense that it is weak on cash compensation, especially up front, and heavy on pensions and health benefits for the retired teacher. This is what one would want if the idea were to retain the teachers with the most years of service, but it makes no sense if what we are after is to attract young people who are thinking most about how they are going to get the cash they need to enjoy themselves, buy a home, support a family, and pay for college for their children.
>
> The first step in our plan is to make retirement benefits comparable to those of the better firms in the private sector and use the money that is saved from this measure to increase teachers' cash compensation. The plan would also provide salary increments for especially effective teachers, teachers at higher points on a new career ladder, those willing to teach in remote or especially tough urban areas, and teachers in shortage fields like mathematics and special education.

[11] "No One Benefits: How teacher pension systems are failing BOTH teachers and taxpayers," National Council on Teacher Quality, http://www.nctq.org/p/publications/docs/nctq_pension_paper.pdf
[12] "Scrambling the Nest Egg: How Well do Teachers Understand their Pensions and What Do They Think about Alternative Pension Structures?" Urban Institute, June 2010, http://urbn.is/23Yl5uF
[13] "The Unsteady States of America," The Economist, July 2013, http://econ.st/1qXLISk
[14] "Tough Choices or Tough Times," 2007, http://www.skillscommission.org/executive.htm

Other Post-Employment Benefits (OPEB)

A minority of private employers provide OPEB of any nature. In September 2013, both IBM and Time Warner announced elimination of OPEB for most of their U.S. retirees, coupled with contributions to health reimbursement arrangements. Some large companies continue to provide post-retiree medical benefits, and some union employees receive them. Assuming it is legally possible, a prospective option is complete elimination of the current state OPEB system, while using high-deductible health plans (HDHPs) for health insurance for all state employees, coupled with HSAs.[15]

If OPEB can be reformed and the desire exists to fairly phase out OPEB going forward, existing employees could be grandfathered in their current benefits to the percentage their current years of service bears to 30 (meaning a double pro-ration would apply to people falling under the new OPEB system). Existing retirees would not be affected. In lieu of elimination, a reasonable annual contribution (e.g., $1,500) could be made to HSAs of full-time employees to help pay for post-retirement medical costs.

Conclusion

All three layers of government in the United States – local, state and federal – will be tremendously stressed over the next several decades, in significant part due to rising health care costs and public employee retirement benefit promises. If all who can will reasonably sacrifice, all systems can be preserved.

Georgia can position itself to be competitive for business in the future by getting its retiree benefits obligations under control. A hybrid pension, defined contribution or cash balance approach to retirement benefits is the best means of fairly tying taxes to current work performed, providing retirement security to government workers and retirees, reducing financial risk exposure, and eliminating the political incentives of promising current benefits funded by future generations.

The Georgia Public Policy Foundation is grateful to Senior Fellow Leonard Gilroy, Senior Managing Director of the Pension Integrity Project at Reason Foundation, for his contribution to the Pension Reform Chapter of the Guide to the Issues.

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[15] An HSA is a health savings account, as defined in Internal Revenue Code § 223. It is similar to an IRA except withdrawals for health care purposes are tax-free.