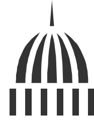

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State Pension Reform in 2010 and 2011

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In order to address the funding problems of state retirement plans state legislatures enacted more legislation on the subject in 2010 and 2011 than any previous year had seen. In 2010, 21 states changed their public pension plans in ways ranging from restrictions on the ability of retired people to return to a job covered by a public pension to completely restructuring plans. In 2011, through the end of October, 28 states enacted comparable legislation. In late 2011, additional reforms were in the legislative process in Massachusetts and Rhode Island.

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 the average funding ratio for 126 statewide plans (including the District of Columbia) reached a record high of 103 percent of accrued liabilities. Since then, two recessions have battered their assets. State budgets were shrunk by the same recessions. The slow recovery from the last recession has made it impossible for states to rebuild pension system assets. Some systems have also suffered from of inadequate state contributions and unfunded increases in 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, depend on accepting state retirement plans' assumptions about the value of their assets and the future investment return on them. Skeptics view the plans' assumptions as unduly optimistic and have contended that some retirement funds are so poorly funded, when valued as the skeptics recommend, that they may run out of assets within a decade.[3]

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[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.

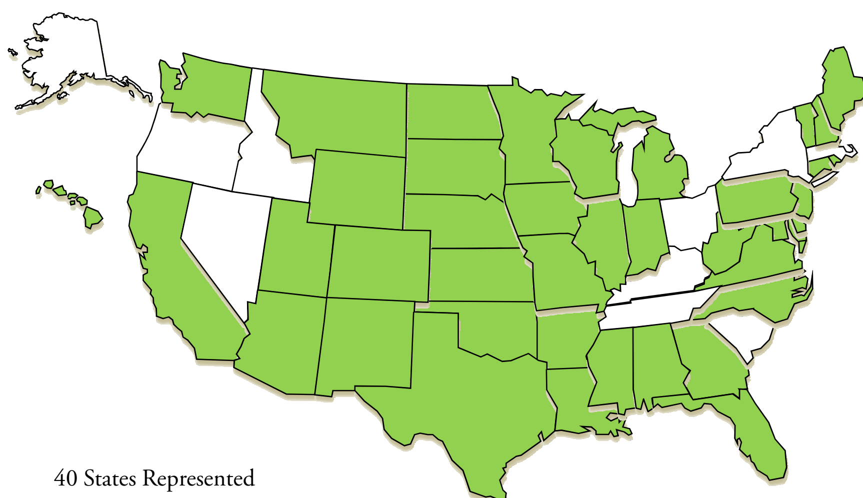
The financial condition of retirement plans was a continuing concern in 2010 and 2011. Added to it were the aging of the state workforce and its increased propensity to retire, the inability of state budgets to accommodate higher employer contributions for years to come, questions about the different 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 in 2010 and 2011

These issues have resulted in a record amount of legislation in 2010 and 2011 to restructure the contribution and benefits provisions of state retirement plans.

Figure 1 shows the 40 states that enacted significant pension reform legislation for at least one statewide retirement plan for state employees or teachers from the beginning of 2010 through the end of October, 2011.

Major Pensions Legislation in 2010 and 2011



These changes included:

- In 2010, 18 states increased mandatory employee contributions or age and service requirements for pension benefits, or both. In 2011, 22 states did so. In the six legislative sessions from 2005 through 2009, only a total of 17 states had taken such actions.
- In 2010, 12 states increased the amounts members must contribute to their retirement plan. In seven states, the increase affected current employees and in five only new hires. Three of the latter group (Missouri, Utah and Virginia) previously had not 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. Wyoming required that current and future employees make contributions that previously had been paid by employers. In 2011, 17 states enacted increases in employee contributions, including those required from at least some current employees in 14 of the 17 states. Since some states made this change for different plans in the two years, 25 states in all have increased some employees' contributions over 2010-2011.

- A important new trend in 2011was to offset increases in employee contributions with reductions in employer contributions, which 10 states did. Such a shift from employer to employee contributions is not neutral for a retirement fund, even if the percentage changes are equal. That is because members who leave a system can withdraw their contributions. The change can mean such members can withdraw a higher share of the total contribution to the plan. Employee contribution increases that are coupled with employer decreases can reduce or restrain growth in the employer's obligation, but do not strengthen the funding of the retirement plan.
- In 2010, 11 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, and in Colorado members of the Public Employee Retirement Association who have less than five years' membership. In 2011, 15 states enacted higher age and service requirements for benefits, again generally for new hires.
- In 2010, 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 affected current members with less than 10 years of membership, and in Colorado, Minnesota and South Dakota, the reduction affected people already retired as well as those who retire in the future. The legislation faced legal challenges in each of those last three states as an unwarranted breach of contract. In 2011, nine states reduced their commitments for future post-retirement benefit increases. In five of those states (Arizona, Florida, Maine, Maryland and New Jersey), the changes affect current employees, and in Maine and New Jersey, people already retired as well. Changes in Washington eliminated or limited future benefit increases for members of two closed plans.
- In 2010, eight states provided for longer periods for calculating final average salary (final average compensation), which is the basis for pension benefits. Five states did so in 2011. A longer period usually means a longer base for the benefits.
- In 2010, nine states reduced benefits available to those who take early retirement. Six states did so in 2011.
- In 2010, 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. Six states did so in 2011.

Almost all the 2010 and 2011 legislation was within the framework of traditional defined benefit retirement (DB) plans, the standard retirement provision in the public 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 defined benefit (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. Employees are not required to contribute to the plan but 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 (more 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.

A number of other states considered the adoption of defined contribution plans as basic coverage in 2011, although none of them did so. The issue remains under consideration; for example Arizona and Kansas study commissions will make recommendations on the issue to their legislatures in early

2012. At the end of 2012, governors in California and Rhode Island have recommended the adoption of a combined (hybrid) plan somewhat similar to the Utah model.

In part, the reluctance to move away from traditional defined benefit plans grew out of concerns about transitional costs. Adopting a new plan which may in itself be less expensive for employers does not address the problem of legacy costs—any existing unfunded liability for a closed defined benefit plan. Legacy costs could mean an increased burden of employer contributions for closed plans as their membership falls over time. Support for such changes remains strong (as does opposition to such changes) and the issue will remain alive in 2012, as will the need to enact less fundamental plan revisions to address the ongoing pension funding problem.