Pension Reform

Principles

- Any pension changes should protect the current benefits and future expectations for employees already in the system.
- The new system should become better aligned with today's more mobile workforce and more competitive with other private and public sector retirement plans.
- Benefits under the new system should accumulate more evenly over employees' careers.

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.

	Liability	Percent Funded	Rank
Georgia Pensions	$81,093,057	85 percent	10th best funded
Georgia Retiree Health Benefits	$19,804,096	3 percent	17th best funded

Source: The Pew Center on the States[1]

Recommendations

- Create a defined contribution or hybrid pension plan for all newly hired teachers and give already hired teachers the option to participate
- Replace retiree health benefits with up-front, annual contributions to employees' Health Savings Accounts

Overview

The required taxpayer-funded employer contributions to Georgia's two major retirement systems, the Employees' Retirement System (ERS) and the Teachers' Retirement System (TRS), have been growing at an alarming rate in recent years. The increases are expected to continue.

Required employer contributions to the "old plan" component of the ERS grew from 10.41 percent of compensation in 2011 to 14.90 percent in 2013, and they are expected to grow to 17.21 percent in 2015. TRS required employer contributions grew from 9.28 percent of compensation in 2009 to 12.28 percent in 2014, with the 2015 contribution rate expected to be 13.15 percent. These employer contribution rates are much greater than employer contributions to retirement systems in the private sector, even when Social Security is taken into account. Compared to other states' plans, while not extravagant, the ERS and the TRS are relatively rich in terms of overall benefits provided relative to required employee contributions.

Many studies show that government employees receive greater compensation than their private sector counterparts. While some studies produce opposite results, all studies show there is much greater job security in the public sector than that which exists in the private sector.

Both the ERS and the TRS rely on actuarial factors to determine annual contributions. These factors are not exact, with the result that current taxpayers end up paying either more or less than

[1] "The Widening Gap Update," The Pew Center on the States, June 2012, http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Pensions_Update.pdf

their fair share of deferred compensation currently earned by state employees and teachers, while future taxpayers will correspondingly pay more or less than their fair share. Transitioning to a defined contribution system, as is widely prevalent in the private sector and is growing by the day in the public sector, would eliminate the potential for unfairness.

Accounting rules effective beginning July 1, 2014, for the ERS and the TRS will significantly change the method of accounting for deferred compensation for government employees. While the Other Post-Employment Benefits (OPEB) rules are still in a state of flux (with resolution anticipated this year), the new pension rules are set, and they will significantly reduce the funded status of all governmental plans, including the ERS and the TRS. If the OPEB rules ultimately adopted are in line with the pension rules, then the combined pension/OPEB unfunded liability for the ERS and the 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.

Employees under age 30 earning less than $35,000 annually – who made up 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 and closed the traditional defined benefit plan for new hires.[2] All employees hired after January 1, 2009, participate in the hybrid plan, while current participants in the ERS plan may choose to join the hybrid plan at any time.

This approach also makes sense for teachers

The range of options possible for remaking the TRS, include defined contribution plans such as the popular 401(k) and IRA models, traditional pension plans, hybrid retirement plans that combine features of the first two and even combinations of these different types. The important principle to adopt first is that the TRS should be modified to be more in line with plans of other employers and fairer to teachers and taxpayers.

Challenges with the Teachers' Retirement System

The TRS, a significant cost to taxpayers, 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, it should be replaced for new hires.

The majority of Georgia's teachers are hired at a young age, often right out of college. For this group of employees there are several issues that make the TRS uncompetitive:

- **Vesting**: Any employee who works less than 10 years forfeits all employer-paid benefits (they do keep their own contributions, plus interest). Consider that for a moment – a prospective employer tells you, "We have a great retirement plan, unless you leave

[2] Center for Retirement Research at Boston College, http://crr.bc.edu/wp-content/uploads/2011/09/Georgia-2.pdf

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 the TRS grows slowly for the first 10 to 15 years, then the value growth begins to accelerate. As they approach retirement the value climbs dramatically. Employees who stay until retirement age are well rewarded (this is often referred to as backloading). While this approach was common many years ago, it does not fit today's workforce.
- **The flip side of "backloading**:" Because of the significant backloading of benefits under the 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.

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 percent 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."[3]

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."[4]

Urban Institute:

[3] "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
[4] "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

"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."[5]

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 honoured, 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."[6]

The Commission on American Workforce Skills, chaired by past University of Georgia President Charles B. Knapp:[7]

"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."

Pension Reform in Other States

Michigan transitioned to a defined contribution (DC) plan in 1997. Since then, new employees have received a 4 percent employer contribution plus dollar-for-dollar match up to 3 percent of

[5] "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://www.urban.org/uploadedpdf/1001426-teacher-pensions.pdf

[6] "The Unsteady States of America," The Economist, July 2013, http://www.economist.com/news/leaders/21582258-it-not-just-detroit-american-cities-and-states-must-promise-less-or-face-disaster

[7] "Tough Choices or Tough Times," 2007, http://www.skillscommission.org/executive.htm

pay deferred by the employee. The change saved the state $2.4 billion over the first 13 years of the new DC plan's existence.[8]

In Alaska, state and school employees hired after June 30, 2006, participate in a DC plan. The employer makes an 8 percent (of compensation) contribution, while state employees contribute 5 percent and school employees contribute 7 percent.

In 2012, Kansas adopted a cash balance plan. Employee participation in the plan will begin in 2015. Employees with more than 24 years of service will receive a 6 percent allocation rate and all other employees will receive a 3 percent allocation rate. The interest credit will be 5.25 percent. Up to an additional 4 percent of allocations will be made, depending on funding levels and investment returns.

Louisiana enacted a cash balance plan in 2012 for employees hired after June 2013 that provides for employee contributions of 8 percent of pay and employer contributions of 4 percent of pay. According to the Tennessee Consolidated Retirement System (TCRS) Reform Options (the TN Analysis,) a Louisiana district court declared the new plan unconstitutional in January 2013 due to the way it was enacted.[9] An appeal was pending.

According to the TN Analysis, South Carolina enacted legislation in 2012 that increases required employee contributions over the course of two years from 6.5 percent to 8.0 percent. The legislation also expanded the compensation period used to determine the pension amount from three to five years, and capped annual COLAs at $500.

Based on the TN analysis, Tennessee is trying to change the way things have been done. Other states are facing up to reality. According to the Pew Charitable Trusts, in 2013 Kentucky faced up to its pension problems, committed to funding, reduced benefits and installed a cash balance plan to apply to employees hired after 2013.

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. However, in the private sector, they are the exception rather than the rule.

Assuming it is legally possible, an option here is complete elimination of the current OPEB system prospectively, while using high-deductible health plans (HDHPs) for health insurance for all employees, coupled with HSAs.[10]

If the facts show that 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 impacted. In lieu of a prospective complete 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.

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[8] "Keeping the Promise: State Solutions for Government Pension Reform," American Legislative Exchange Council, 2013, citing a 2011 conclusion by Richard Dreyfus, an actuary and adjunct scholar with the Mackinac Center for Public Policy.
[9] Tennessee Consolidated Retirement System (TCRS) Reform Options (TN Analysis), dated February 22, 2013
[10] 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.

Conclusion

The baby boom is highlighting the frailties of democracies in the United States and abroad. Voters generally vote for the candidates promising the most and taking the least. All three layers of government in the United States – local, state and federal – will be tremendously stressed over the next 15-plus years. 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 defined contribution or cash balance approach to retirement benefits is the best means of fairly tying taxes to current work performed, providing certainty and eliminating the political incentives of promising current benefits funded by future generations.

Resources / Further Reading:

Much of this article is based on the following study: "A Case for Changing Public Retirement Benefits in Georgia (and Possibly Elsewhere)," Allen Buckley, Georgia Public Policy Foundation, February 25, 2014, http://www.georgiapolicy.org/ftp_files/140127Pensions.pdf

"The Case for Reforming Georgia's Teacher Retirement System," Steve Metz, Georgia Public Policy Foundation, January 23, 2013, www.georgiapolicy.org/the-case-for-reforming-georgias-teacher-retirement-system/

"The Widening Gap Update," The Pew Center on the States, June 2012, www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Pensions_Update.pdf

"The Fiscal Health of State Pension Plans: Funding Gap Continues to Grow," The Pew Center on the States, March 2014, http://www.pewstates.org/uploadedFiles/PCS/Content-Level_Pages/Fact_Sheets/Pew-States-Widening-Gap-Factsheet.pdf

"No One Benefits: How teacher pension systems are failing BOTH teachers and taxpayers," National Council on Teacher Quality, www.nctq.org/p/publications/docs/nctq_pension_paper.pdf

Case Studies from the Reason Foundation Pension Reform site: http://reason.org/areas/topic/pension-reform

"Addressing Common Objections to Shifting from Defined-Benefit Pensions to Defined-Contribution Retirement," Reason Foundation, June 2014, http://reason.org/news/show/pension-reform-defined-contribution

Teachers' Retirement System of Georgia, www.trsga.com

Employees' Retirement System of Georgia, www.ers.ga.gov

Summary of state pension plan reforms, Cammack Retirement, 2014, http://origin.library.constantcontact.com/download/get/file/1102911954578-503/Are+States+Migrating+from+Traditional+Pension+-+A+State-by-State+Review.pdf