The Ohio Society of CPAs

Ohio Budget Advisory Task Force Issue Paper

Pension Reform

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A National Perspective

Forbes.com said, "Public Pensions Face Ugly Choices."[1] Barron's pointed out "The $2 Trillion Hole."[2] The Cleveland *Plain Dealer* reported, "Public-pension tab in Ohio: $4.1 billion – and growing."[3] Headlines across the country point to a growing problem: many public pension systems are underfunded, and the situation is only getting worse.

In the past, public sector salaries were on average lower than their private sector counterparts. It was necessary to provide enhanced benefits, including generous health care and pension packages as an incentive to work in the public sector. For many public employees, that is simply not the case any longer. For example, according to the U.S. Bureau of Labor Statistic figures, public sector compensation averaged $39.66 per hour in 2009, compared with private sector employees whose average was 45% lower during the same time period.[4] The public sector pay advantage is most pronounced in benefits. U.S. Bureau of Economic Analysis data from 2008 show that on average, compensation in the private sector was $59,909 in 2008, including $50,028 in wages and $9,881 in benefits. Average public sector compensation was $67,812, including $52,051 in wages and $15,761 in benefits.[5]

Defined Benefit Plans vs. Defined Contribution Plans

Traditionally, public and private pension plans were established as defined benefit plans. Under this type of retirement plan, benefits are based on a predetermined formula that is not contingent upon investment earnings. In 1974, 71% of private sector retirement-plan assets were in defined benefit plans. By 2008, that number dropped to 24%, according to the Employee Benefit Research Institute. Retirement incomes for the most experienced government employees can be as high as 88% of their top average pay – and they are guaranteed. Conversely, retirement income for most private-sector workers is dependent upon the strength of the stock market and 401(k) plans.[6] Many of those private sector employers had converted from defined benefit plans to defined contribution plans, under which the benefit is determined by how much money is in the participant's account at the time of retirement. Investment earnings from each participant's 401(k) or other retirement savings account play a big role in determining the amount of defined contribution benefit that will be received.

Because a defined benefit plan commits to paying a specific benefit in the future, it typically involves an unfunded liability represented by the difference between the plan's current assets and future liabilities. It is assumed that contributions made by and on behalf of current and future members will provide the

[1] Forbes.com, Nov. 6, 2009
[2] Barrons.com, March 15, 2010
[3] Cleveland *Plain Dealer*, Jan. 3, 2010
[4] U.S. Bureau of Labor Statistics (BLS 2009d)
[5] U.S. Bureau of Economic Analysis
[6] *The Columbus Dispatch*, Jan. 3, 2010

funding needed to pay the promised future benefits. With Ohio's defined benefit plans, with limited exceptions, a member receives a retirement benefit based on a formula that looks at years of service, final average salary, and sometimes age. Ohio state law requires that pension systems have enough money to cover their pension obligations for 30 years.

Nationwide, over $1 trillion worth of municipal pension fund assets were erased in the recent market meltdown. While some of that has been recovered, Forbes.com[7] said the average public pension plan is underfunded by 35% and a wave of municipal bankruptcies could follow. They noted there are four possible solutions to avoid bankruptcy for underfunded public entities: 1) contribute more money from public employees, taxpayers or both; 2) take less money out of the pot, meaning decrease benefits, which is off the table because in most cases workers are legally entitled to any benefits already granted; 3) use existing money to invest in financial markets and defy economic reality by providing spectacular results that wipe out any underfunding; or 4) declare insolvency under Chapter 9 of the U.S. Bankruptcy code, whereby a fundamental restructuring of public pension obligations would be inevitable. Forbes pointed to Jefferson County in Alabama and several California towns as examples of entities close to the bankruptcy option. They estimate that tax bases will continue to suffer and pension shortfalls may well rise above 40% by 2013.

Ohio's Public Pension Fund Systems

While numerous public pension systems are in dire straits, several in Ohio have been recognized as being stable and well run. However, just as is happening with the Social Security fund, rising government employee salaries and retiree health care costs, combined with fewer workers paying into the funds and limited taxpayer assets to support the employer contributions, likely will result in future obligations that aren't sustainable under current pension payment formulas and benefits granted.

Ohio is far from immune with regard to the threat of a future pension funding crisis. Our public pension systems pay for retirement, disability and survivor coverage for 1.5 million members, retirees and beneficiaries and provide for health care coverage to many retired public sector employees. Two of the funds (Ohio State Teachers Retirement System and Ohio Police and Fire Pension Fund) are currently in violation of Ohio's 30-year funding law.

Ohio's five public pension retirement systems – Ohio Public Employees Retirement System (PERS), Ohio State Teachers Retirement System (STRS), Ohio School Employees Retirement System (SERS), Ohio Police and Fire Pension Fund (OP&F) and Ohio State Highway Patrol Retirement System (HPRS) – generally are in good shape today compared to other pension systems in other states, despite STRS and OPF falling below required funding levels. All five statewide retirement systems involve defined benefit plans, though PERS and STRS give certain members the option of contributing instead to a defined contribution plan or a combined plan.

[7] Forbes.com, Nov. 6, 2009

Four of the five Ohio statewide retirement systems are included among the nation's top 200 public and private pension funds.[8] The Pew Center on States issued a January 2010 report giving Ohio high marks, noting ours is one of 16 states[9] labeled a "solid performer" on pensions, and one of only nine to receive that status on health benefits.

U.S. Government Accountability Office (GAO) experts state that pension funds should fund at or above the 80% benchmark. Pew reported Ohio has funded 87% of its total pension bill and met its actuarially required contribution levels. Ohio has set its maximum contribution in statute at 14% of payroll for OPERS, with any extra monies used to fund retiree health care and other non-pension benefits, allowing more than 38% of its nearly $43.8 billion liability to cover long-term costs.

Despite those high marks, the *Plain Dealer* reported that STRS and POF are currently in violation of the state law requiring enough funding to cover 30 years of pension obligations. The Pew study notes that growing costs and shrinking revenues already have and will continue to impact the plans that teachers, police officers and fire fighters and other public employees rely on, including Ohio's. Possible changes Pew predicts include public employees working longer, retirees facing higher medical costs, and taxpayers paying much more.

In addition to the five statewide plans, Ohio has one independent municipal public pension system: the City of Cincinnati's. Cincinnati taxpayers, current city employees and retirees are facing a huge hit – up to $400 million – due to the city's seriously underfunded public pension system. *The Cincinnati Enquirer*[10] said that, for a variety of reasons, the $2 billion municipal retirement fund is in such a long-term financial hole that most ideas on how to regain sound financial footing are politically or financially impractical. Options contemplated by local task force experts include selling city assets, issuing bonds, raising employee contributions, have retirees pay more for health care, or raising – even doubling – the annual contribution taxpayers dedicate to the fund. Experts say the added funding is necessary to avoid projected insolvency by 2030.[11]

The Enquirer noted the task force's exhaustive review pointed to years of inadequate city funding, expanded benefits and escalated health care costs, combined with stock market losses, as the basis of the dilemma. One task force member summarized the situation: "We've got to make up for past sins." Another said, "We've backed ourselves into a corner." Ohio simply cannot allow its statewide funds to replicate this situation.

In Toledo, public employees pay into Ohio's statewide pension fund but are facing a growing taxpayer burden due to previous city labor contracts that shifted millions of dollars of pension payments from city workers to city taxpayers. The projected cost to Toledo taxpayers of the pension "pickup," of the employee portion of their retirement was projected at $13.9 million for 2009. An additional $26.3

[8] *Pensions and Investments*, Feb. 8, 2010 issue
[9] Pew Center on the States, "The Trillion Dollar Gap," February 2010
[10] *The Cincinnati Enquirer*, "Many to feel big hurt over Cincinnati's pension woes," March 31, 2010
[11] *The Cincinnati Enquirer*, "Tough options in city pension crunch," March 22, 2010

million in liability is due for the employer's share of their pension.[12] Columbus is another city that picks up the employee portion of the pension contribution, at an estimated cost of $43 million per year.[13] City leaders are taking steps to address this taxpayer burden.

Other than in Cincinnati, all Ohio local and state employees participate in one of our state's five state pension funds. And while the current fiscal crisis Cincinnati is facing hasn't been seen in state government, steps need to be taken – and soon – to avoid the specter of a statewide pension crisis here in our own state as growing costs and shrinking revenues will impact the plans that teachers, police officers and other public employees rely on.

To counter future potential shortfalls, in September 2009 leaders of Ohio's public pension funds detailed to the Ohio Retirement Study Council (ORSC) a number of suggested changes to improve the funding status of the multi-billion dollar program, acknowledging the need for changes to shore up the funds' balances. Many of the proposed changes require legislative action, though others can be made by the pension systems themselves. Legislators and retirement system leaders alike recognize that a continued reliance on stock market gains won't return the state's pension funds to their targeted funding period, and that changes must be made.

The stakes are enormous for taxpayers, public sector employees and retired public workers alike.

There are generally three sources of revenue used by the Ohio retirement systems to fund their defined benefit pension benefits: 1) employee contributions; 2) employer contributions; and 3) investment earnings. Investment earnings typically have been the largest source of revenue for the Ohio retirement systems, funding up to 75% of the benefits paid in past years. However, stock market losses showed how vulnerable all of the funds are to cyclical changes and major problems. A semi-annual investment review presented at the ORSC meeting in October 2009 found that all five systems have ten-year returns that are below their current actuarial interest rate assumptions due to recent market conditions. A report presented to the ORSC in April 2010 reaffirmed that investment returns alone will not help the systems meet their 30-year funding goals; the pension funds must also adjust funding and benefit policies.

Clearly, changes must occur to meet funding requirements and ensure public sector employees are given the pension payments they are legally entitled to receive, yet also recognize the reality that limited taxpayer resources are available now and in the future. The OPF, one of two pension funds that suggested increasing the employer and/or employee percentage of contribution, recommends increasing the employer portion to 25% of salary, and employee portion to 12%. Under this scenario, those municipalities that "pick up" the employee share would pay 37% on top of salary directly to employee retirement accounts. STRS recommends school districts increase their contribution for teachers' retirements to 16.5%, and raise the teachers' share to 12.5%. Few cities or school districts can afford that added financial burden, particularly when considering that some cities and school districts cover all or part of the employees' share of retirement costs in addition to their own employer

[12] *Toledo Blade*, Jan. 4, 2010

[13] City of Columbus Compensation Audit, Oct. 2, 2009

obligations. With police and firefighters, that means that a city would have to budget for 37% on top of salaries, and for school districts, 29% on top of salaries. Ohio taxpayers simply cannot afford that level of financial burden.

Activity in Other States

As with the private sector, many public sector employers around the country are recognizing that they need to at least explore the option of moving away from a defined benefit plan or making other changes.

Some states, including Michigan[14], have been advised to shift from defined benefit plans to defined contribution plans. Most states provide a lower percentage of contribution in public pension funds by augmenting those retirement dollars with participation in the Social Security system. While OSCPA is not specifically advocating that government make such a change, it is not feasible to continue the status quo for relatively recent hires or future workers. At a minimum, changes need to create greater equity with the private-sector.

New Jersey state employee pensions are underfunded by $46 billion and health care by $67 billion. To address those significant – and growing – shortfalls, Gov. Chris Christie recently signed into law legislation that is designed to save taxpayers billions of dollars over the years by making pensions and health benefits for public sector workers less generous. Under the new policies, all government workers would be required to contribute at least 1.5% of their salaries toward health care costs, the amount of unused sick and vacation time workers can cash out at retirement is capped, and part-timers would be barred from enrolling in the state pension system, among other revisions.[15]

Ohio Activity

Retirement income for the most experienced Ohio government employees tops out at 88% of their active-duty pay. While most don't receive that level of compensation, all public employees participating in the defined benefit plan do receive a guaranteed amount for the rest of their lives. The private sector's retirement plans are contingent upon the strength of the stock market and their 401(k) plans.

On the private sector side, employers have made a significant shift away from defined benefit plans due to the cost. That shift has not been mirrored with Ohio's public employee retirement systems.

Ohio government retirees can retire as young as 48 for police and firefighters, or others who begin their government service at age 18. The traditional age needed to qualify for retirement benefits in the private sector is 65. The retirement age to receive full Social Security benefits is between 65 and 67, depending on year of birth. While increasing the public pension retirement age will minimize the appeal, the practice of retiring and rehiring, more commonly known as "double dipping," is a growing concern in part because of the revenue impact. In most public sector cases, it is perfectly legal to work past the age when you can collect a guaranteed pension (often 50 or 55), or retire that year and come back to your

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[14] Michigan Turnaround Plan, BusinessLeadersforMichigan.com

[15] Bloomberg *Businessweek*, March 23, 2010

old desk or one nearby to collect the pension and a paycheck. In some states, that practice has been banned. In Florida, taxpayer outrage over elected officials who double dip led the legislature in June 2009 to tighten laws for future retirees, and to release information on all 10,779 state and local government double dippers.

Florida, Delaware, New York, Texas and other states have tightened rules on the practice by limiting the number of days a returnee can work, extending the number of waiting days before returning, or requiring waivers.[1] Starting July 1, 2010, Florida public officials who complete their state's Deferred Retirement Option Program, or DROP, and plan to return to their jobs will have to stay out at least six months. In addition, if they do return to their jobs, the rehired employees will have to wait one year from their retirement date before they may collect pension benefits.[1]

Health Insurance Coverage for Public Sector Retirees

All fifty states provide health insurance coverage to at least some portion of their public sector employees. For some local government and school district employees, the employer pays 100% of the premium costs for a basic or standard health plan for individual employees. In the private sector, it is unusual for employers to pay 100% of the employee and employer share of health care premiums. In recent years, health care costs have increased by double digits for both the employer and employee. State and local governments have only two options to reduce health care costs: shift more costs to the government worker or reduce the cost of the plan through actions such as pooling health care benefits with other governmental entities or decreasing benefit coverage.

Across the country, many state and local government entities provide health benefits to retirees at little or no cost. In some states that trend is coming to a halt. For example, in 2009 New Hampshire began withholding a charge of $65 per month for retired state employees under the age of 65 who are covered by retired employee health insurance ($130 for covered retiree and spouse).[1] Bottom line, governmental entities, including those in Ohio, cannot sustain the current level of funding of health care coverage with active workers, particularly when considering the ever-increasing number of retirees receiving benefits. While providing retirement pensions to current government employees is mandated, providing health care to retirees is optional.

Public Pension Systems: Ripe for Reform

Since a major portion of all state and local government funding is dedicated to personnel costs, pension reform can play a significant role in the future economic success of Ohio, its municipalities and its school districts.

OPF and STRS are asking for rate increases that could, over the next five years alone, increase pension payments by taxpayers to as much as $5 billion a year.[16] In any economy, that scale of additional spending would be difficult to accept, but with the existing fiscal challenges state and local government face, not to mention individuals and businesses that ultimately will bear the burden, it is unthinkable.

[16] Cleveland *Plain Dealer*, "Public pension tab in Ohio: $4.1 billion – and growing," Jan. 4, 2010

Interestingly, one state pension fund representing school employees, SERS, has not asked school districts to contribute more to employees' retirements. A spokesman for this fund acknowledged that forcing districts to pay more in contributions would cause them to make cuts elsewhere. We applaud their efforts to recognize the impact such cuts would have on students.

A computer analysis by *The Columbus Dispatch* found that if the rate increases were approved, the pension cost to local governments, which stood at $4.1 billion a year in January 2010, will grow by $604 million to $768 million during the next five years if current trends continue, with taxpayers potentially picking up $400 million a year of that by 2020. Very few government entities in our state can afford to take on that burden. Taxpayers footing the bill would have little desire to pay more to fully fund public sector pensions – most of which are more generous than their own -- when they have difficulty saving for their own retirement.

We echo concerns that that have been expressed by some members of the Ohio Retirement Study Council: when additional tax dollars or service cuts are needed to shore up public sector retirement systems, cost controls are needed, particularly if performance audits or other studies show that public sector pensions are disproportionately generous compared to retirement benefits received by those in the private sector.

Salaries also are relevant in retirement considerations because they ultimately drive pension costs. Where salaries are concerned, the *Plain Dealer* reported[17] that U.S. Department of Labor statistics found there is virtually no difference between private-sector and public-sector pay in Ohio despite a long-held belief that public sector workers trade a lower salary for more generous benefits, such as retirement pay.

Numerous options exist to help reduce overall pension costs while still meeting legal and moral obligations. While different solutions may work better for each of the five pension systems based on their particular financial status and future risks, there are some changes that should be considered across the board.

Suggestions

Overall, we strongly believe that public sector pension benefits should be much more in line with retirement benefits provided to private sector employees. OSCPA appreciates the efforts of the Ohio Retirement Study Council and the five pension funds to address pension reform, but their suggestions don't go far enough. OSCPA supports the following specific recommendations:

- **Examine issues related to the correlation of salaries to pension benefits.** In its February 2010 State of the State Report, the Buckeye Institute reported that, in 85 out of 88 counties state workers earn much more than their private sector workers and in 57 out of 88 counties local public sector workers earn more than their private sector neighbors.

[17] Cleveland *Plain Dealer*, "Public pension tab in Ohio: $4.1 billion – and growing," Jan. 4, 2010

Where annual salaries are concerned, the Buckeye Institute found that 288 state employees made over $100,000 in 2003, averaging $125,748 in gross pay. Using the current formula, they would earn almost $83,000 a year in retirement, excluding the health care benefits they would also receive. In 2008, the number of state employees making over $100,000 rose to 1,767, an increase of 514%. Assuming an 18-year retirement, the aggregative gross pension pay for those 1,767 employees would be $2.4 billion.

No one can dispute that the higher the average wage being used to determine retirement income, the higher the required payouts for years to come. While OSCPA believes that all workers should be fairly compensated, the reality that Ohio's pension systems allow a high percentage of an employee's top three years' salary – including overtime – to be guaranteed for life. Unlike with Social Security for private sector workers, Ohio's public sector retirement payments do not have a maximum threshold where annual income is concerned. For example, with Social Security payments, no matter how much in annual income a person makes, if they retire in 2010 at age 66 the most they can receive annually is $28,152.[18] Cost of living adjustments would factor in after that, just as they do with the state pension funds. While we are not suggesting that pension payments be limited to the amount of Social Security, we do recommend examining a salary cap on the highest salary amount that will factor into setting pension payments.

- **Study public/private sector compensation parity**. Conduct a study comparing private sector compensation and benefits to those offered in the public sector to ensure they are neither too high nor too low. The findings should be used to address any inequities.
- **Change the automatic 3% annual cost of living adjustment**. Where the Social Security COLA is concerned, the Social Security Act specifies a formula for determining each COLA. In general, a COLA is equal to the percentage *increase* in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) from the third quarter of one year to the third quarter of the next.

  We believe the COLA should be tied in some way to the Consumer Price Index.
- **Ban employer "pick up" of employee's pension payment**. While it is appropriate for public sector employers to pay the employer portion of the defined benefit plan, it is not fair to require taxpayers to also pick up the (currently) 10% employee share. While such a practice may not be widespread, it is extremely costly to cities, school districts and the State of Ohio. Legislators should ban the ability of public sector employers at the state and local levels to pick up the employee contribution. A phase out period over a reasonable timeframe should be considered for employees now receiving this benefit. A compensation audit by the City of Columbus found that taxpayers will save $43 million each year by stopping this practice. And that's just one jurisdiction.

[18] www.ssa.gov

- **Scale back generous early retirement programs.** Deloitte found that many of the provisions contained in such programs are proving to be extremely expensive and poorly designed given that a huge number of aging Baby Boomers are near retirement age. Ohio should investigate this program to see if any changes are needed.

- **Increase the minimum retirement age**. To limit future crises with state pension funds and save significant expenditures, Ohio should further explore best practices with regard to raising the age at which employees can receive pension payments. This should include current practices for comparable jobs in the private sector. While certain positions, such as police officers and firefighters, understandably retire at a younger age than employees not serving in physically trying roles, increasing the minimum age from 48 to 65, which is the common retirement age in the private sector, would save a significant amount of taxpayer dollars. Another benefit of increasing the retirement age to mirror that in the private sector is that it would limit the attractiveness of "double dipping," a system in which government workers can "retire" on a full pension and go back to work the next day, often at full pay and doing the same job. The *Plain Dealer* reported that, together, STRS and PERS paid almost $1 billion last year to these so-called "double dippers."

- **Change the "top three years" formula**. Ohio public employees use the highest three years of income to help determine their annual retirement income. Some public employees are able to take advantage of this method by securing large end-of-career pay raises that raise payments for years to come. The Buckeye Institute pointed to a state legislator who was hired by a university at a much higher salary toward the end of her career, resulting in an increased starting pension payment from $54,212 to $211,200 a year[19]. OSCPA believes this "three-year" provision is a loophole that must be closed. Further, if legally possible, overtime pay should not be counted when determining annual income for this purpose. We support the position that the three-year formula be expanded to at least five years.

SUMMARY

While several of Ohio's statewide pension systems have done an admirable job in past years in fully funding their future financial pension obligations, our state cannot afford to continue the status quo. Changes in the private sector have been made to reflect the realities of our nation's economy and the public sector must also examine ways to treat employees fairly yet realistically. We urge the Ohio General Assembly, Ohio Retirement Study Council and the state's pension funds to full explore all possible options, and to do their part in helping Ohio regain its position as a national leader.

[19] Buckeye Institute – The Grand Bargain is Dead, p. 7