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Kentucky's Pension Challenges: Opportunities for Real Reform

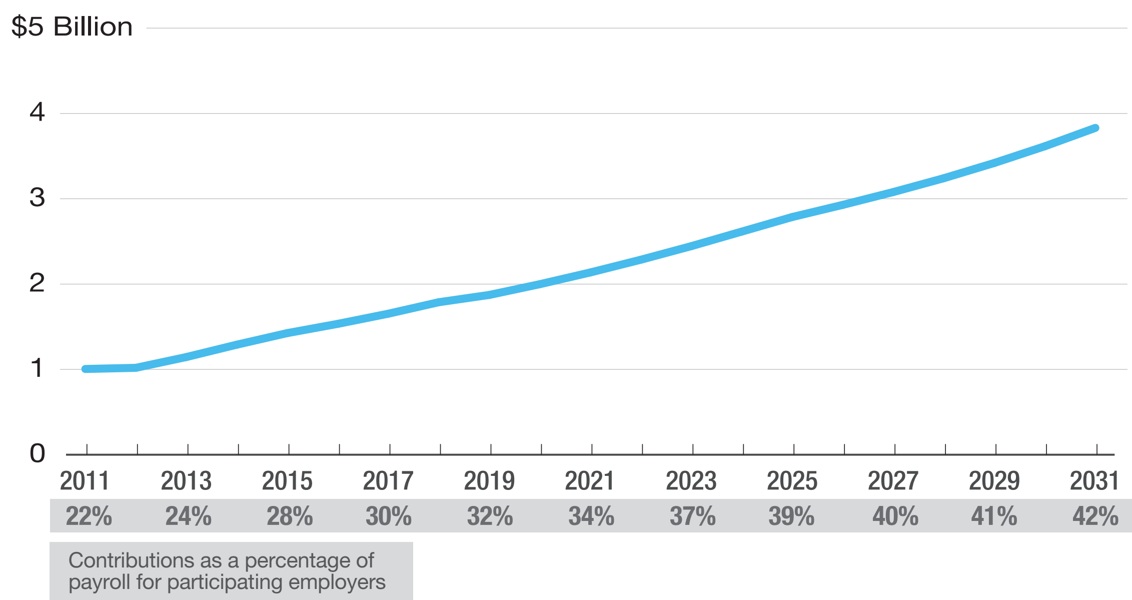
KENTUCKY

The funding level of Kentucky's public-employee retirement systems has declined every year since 2000. Though the state's pension plans collectively ran a surplus as recently as 2002, by 2011 they had on hand just 53 percent of the assets necessary to meet their long-term pension obligations for state and local government employees as well as teachers.

This rapid descent occurred despite the significant sums Kentucky has spent recently to cover these obligations. About $1 billion of taxpayer funds went into the five Kentucky Retirement System plans in 2011 alone for both pensions and retiree health care. That's more than 22 percent of payroll for members of those pension plans. In 2031, unless current policies are changed, the annual pension bill to taxpayers will reach $3.8 billion, which will equal over 42 percent of payroll.

EXHIBIT 1:

PROJECTED STATE AND LOCAL CONTRIBUTIONS INTO THE KENTUCKY RETIREMENT SYSTEM



SOURCE: Kentucky Retirement System, 2012

Today, Kentucky faces a $23.6 billion shortfall between what should have been set aside to pay future pension benefits and what has already been set aside. That sum is more than twice the revenue delivered by Kentucky's entire tax system in 2011. While recent concern has been focused on the Kentucky Retirement Systems due to ongoing scrutiny by the Kentucky Public Pensions Task Force, other public pension plans are important contributors to the state's fiscal challenges. In particular, the Kentucky Teachers' Retirement System is the source of almost half the unfunded liabilities facing taxpayers.

Debates over retirement benefits can easily turn contentious and unproductive. However, it is important to remember that pension problems, such as those in Kentucky, are rooted in simple math, rather than in political ideology. Solving these problems requires recognition by all parties that the state must fix them through sound policy, and that the state cannot rely on the stock market to wipe away its pension debt. As a study commissioned by the Kentucky Retirement System found, there is no available investment strategy that would let the state "invest its way to significantly improved financial status."

EXHIBIT 2:

PENSION FUNDING LEVELS BY PLAN, 2011

Plan	Assets	Liabilities	Unfunded Liability	Percent Funded	Share of Unfunded Liability	Annual Recommended Contribution	Actual Contribution	Percent Contributed
Kentucky Employees' Retirement System (Non-hazardous)	$3,727	$11,182	$7,455	33%	32%	$382	$194	51%
Kentucky Employees' Retirement System (Hazardous)	$511	$722	$211	71%	1%	$21	$19	93%
County Employees' Retirement System (Non-hazardous)	$5,630	$8,918	$3,288	63%	14%	$219	$249	113%
County Employees' Retirement System (Hazardous)	$1,780	$2,859	$1,079	62%	5%	$79	$85	108%
State Police Retirement System	$286	$634	$348	45%	1%	$18	$12	69%
Judicial Retirement Fund	$178	$311	$133	57%	1%	$10	$4	44%
Legislators' Retirement Fund	$38	$66	$28	58%	0.1%	$2	$1	44%
Kentucky Teachers' Retirement System	$14,908	$25,969	$11,061	57%	47%	$679	$573*	84%
KRS Subtotal	$11,933	$24,315	$12,382	49%	52%	$718	$559	78%
Total	$27,057	$50,661	$23,604	53%	100%	$1,409	$1,137	81%

* Does not include $465 million in proceeds from pension obligation bond sales.
All figures are in millions of dollars.

SOURCE: Pew Center on the States, 2012

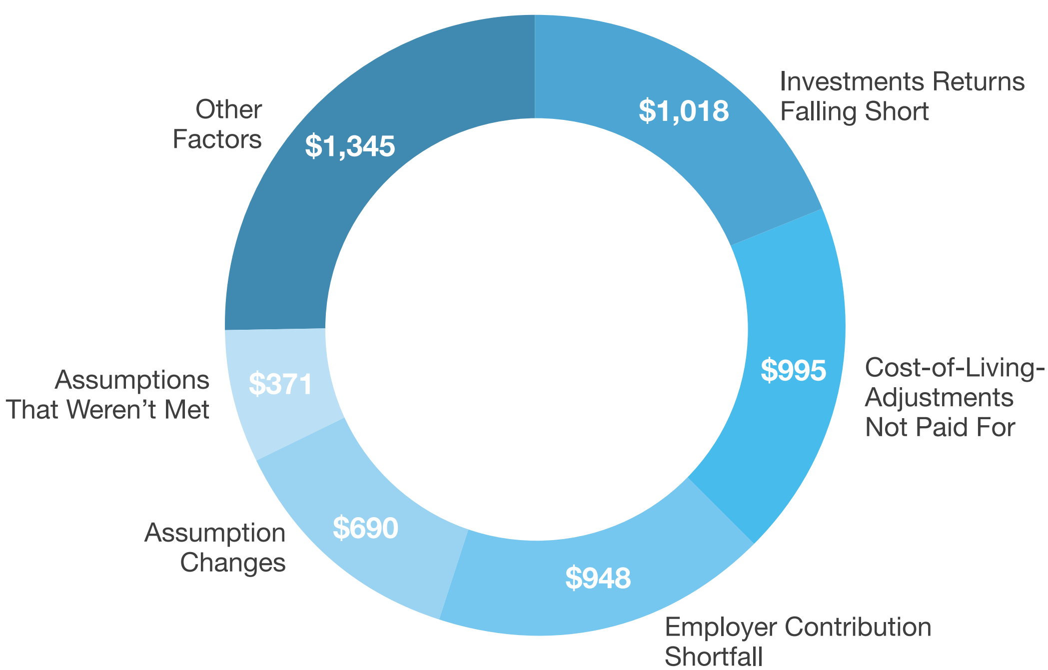
What Went Wrong?

Although the state has engaged in a series of reforms of its pension system in the past half dozen years, the funding gap has continued to grow. From 2006 to 2011, the unfunded liability for one plan—the Kentucky Retirement Systems–Non Hazardous Plan—increased by about $5.5 billion. The unfunded liability increased for multiple reasons, including:

- The devastating stock market losses of recent years added approximately $1 billion to the shortfall as expected investment returns did not materialize.
- Repeated failures by the state to make its annual recommended contribution in full caused the gap to grow by about $1 billion.
- Another $1 billion was the result of cost-of-living adjustments that were given without adequate funding.
- As happened in many states, past actuarial assumptions, such as for salary growth and retirees' life expectancy, proved to be incorrect. Corrected calculations added another $1 billion to the plan's unfunded liability.

EXHIBIT 3:

SOURCES OF INCREASES IN THE UNFUNDED LIABILITY IN THE KENTUCKY EMPLOYEES' RETIREMENT SYSTEM (NON-HAZARDOUS) – 2006 TO 2011



All figures are in millions of dollars.

SOURCE: Kentucky Retirement System, 2012

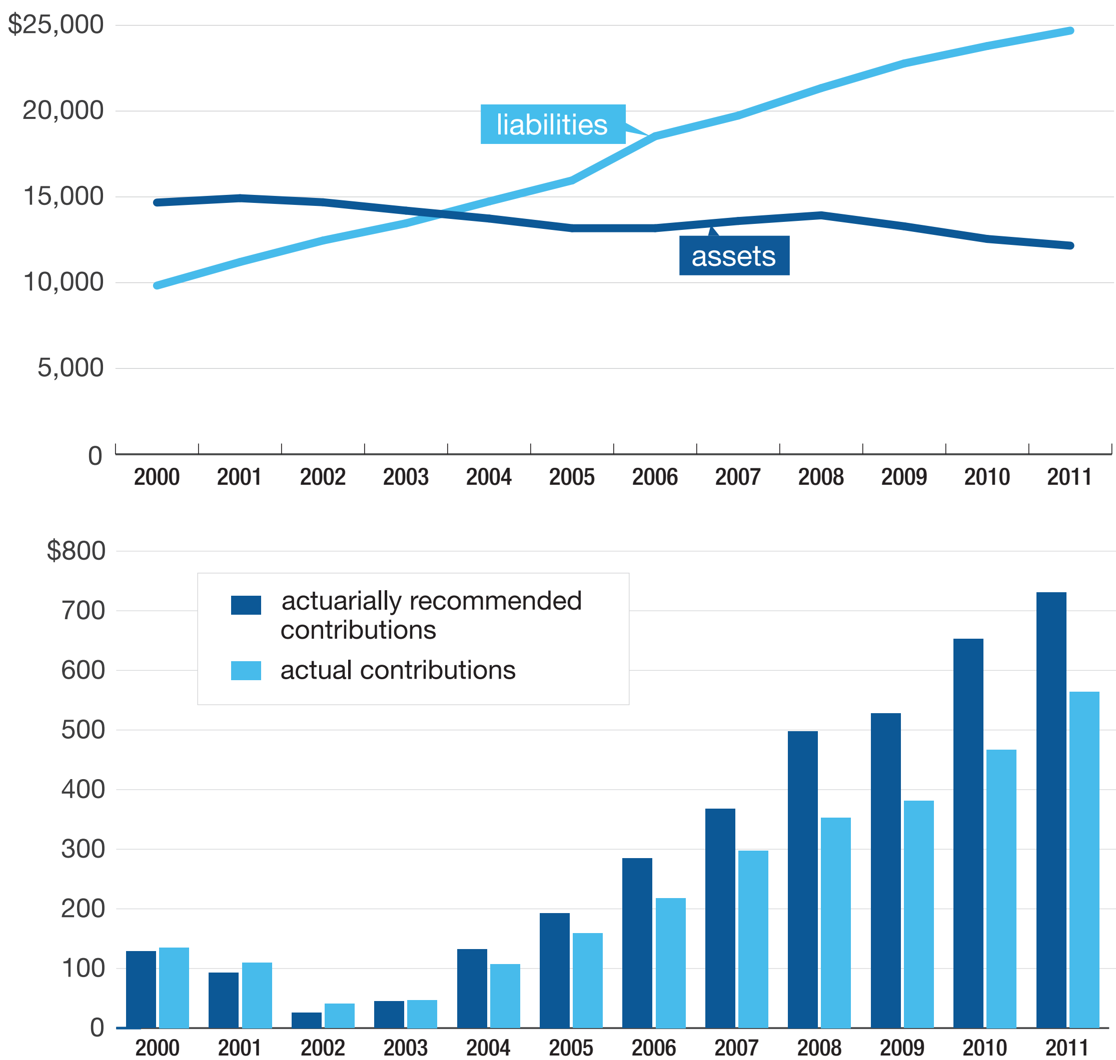
While several of the factors that influence pension cost are beyond policy makers' control, the single factor that is most firmly in the hands of state leaders is the amount the state contributes to the fund each year. Since 2004, the state has had a poor record on this front, and has not paid a sufficient amount into the fund to ensure its ability to fully pay benefits into the future.

In 2011, for example, state and county governments contributed $560 million to the Kentucky Retirement System's pension plans. Even though this was a hefty $400 million more than the 2005 contribution, it still fell short of the recommended amount by $160 million.

EXHIBIT 4:

KENTUCKY RETIREMENT SYSTEM – PENSION FUNDING AND CONTRIBUTIONS OVER TIME

All dollar figures are in millions



These figures are for the Kentucky Retirement System and do not include the Kentucky Teachers' Retirement System, the Judicial Retirement Fund, or the Legislators' Retirement Fund.

SOURCE: Pew Center on the States, 2012

Under Kentucky's current retirement savings system, the state can get hit with unexpected cost increases that can be difficult to absorb. Because pension plans depend on investments to fund the majority of employee benefits, retirement costs increase when the economy struggles. Policy makers are asked to kick in more when they also are facing declining tax revenue and budget cuts. The result has been predictable—missed payments and growing shortfalls.

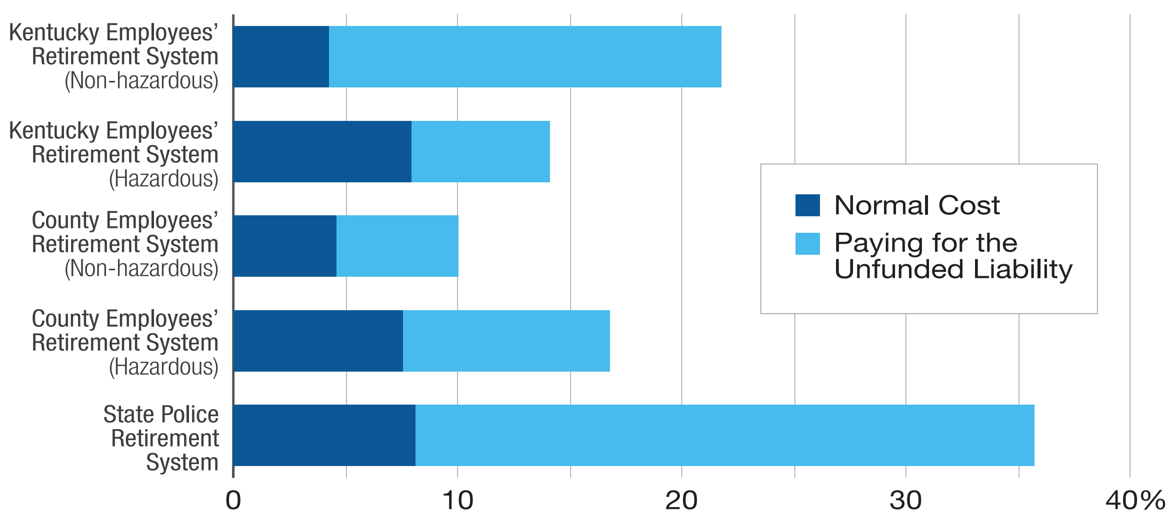
During the past six years, taxpayers put into the Kentucky Retirement System about $775 million less than actuaries have called for to adequately fund the states' pension promises. The result is a cascade effect: Each time the state shortchanges its contribution, the unfunded liability grows. And as the unfunded liability grows, so, too, does the following year's recommended contribution. Currently 63 cents of every taxpayer dollar that goes into the Kentucky Retirement System pays for past promises rather than for new benefits.

Escalating annual payments have put ever increasing pressure on the state's already strained budget.* Without more substantial and comprehensive reform, the state faces the challenging choice of increasing taxes or cutting back on services to afford the retirement benefits it has promised.

* Annual pension payments are made up of two factors. One—dubbed the "normal cost"—provides the necessary funding for the retirement benefits employees earned that year. The other pays a portion of the unfunded liability that has been allocated—or amortized—over a number of years.

EXHIBIT 5:

MOST OF THE ACTUARIALLY APPROPRIATE CONTRIBUTION RATE IS TO PAY FOR PAST PROMISES



SOURCE: Kentucky Retirement System, 2012

The Road to a Sustainable Pension System

Policy makers now need to make the hard choices to secure the state's retirement plans for both current and future generations of workers and taxpayers.

Changes that took place in 2004 and 2008 provided some help, but not nearly enough. Those reforms included a shift away from cost-of-living increases based on the consumer price index and a move to an automatic 1.5 percent increase that could be suspended if the General Assembly desires (as it did for fiscal years 2012-2013 and 2013-2014.) The 2008 reforms also made some changes to the pension formula for new employees, including a graduated scale for the multiplier that is used in calculating benefits and a change in the way final salary is calculated. While these changes have led to modest long-term cost reductions, pension cost is still set to rise to unmanageable levels in relatively short order. And while the anticipated cost of benefits for new employees is low, the state is still taking on substantial risk, particularly investment risk, and it lacks the flexibility to manage that risk should reality not match predictions. Additionally, employer contributions are not guaranteed, so workers remain vulnerable to future policy makers failing to make the annual payments.

Making costs manageable may require current employees and retirees to further share the load by either paying more in employee contributions or accepting reduced retirement benefits going forward. While not ideal, this strategy is hardly without precedent. In some states such as Arizona, employees and employers share equally in the contribution for benefits, and therefore share a more equal portion of the risk.

Regardless of how policy makers choose to do it, the state needs to pay down its retirement shortfall and have the fiscal discipline to make the required payments in both good times and bad. Without this discipline, no system is sustainable. Beyond responsibly paying for employee benefits, pension reform also must meet workforce needs, provide retirement security, and fairly share risk between taxpayers and employees. States such as Georgia, Nebraska, and North Carolina have shown that it is possible to provide an affordable, sustainable retirement benefit that provides solid retirement security. And Rhode Island's recent adoption of comprehensive reform demonstrates that even states in the most dire of circumstances can find solutions.

Through this process, Kentucky must confront a few challenges that stem from its current retirement system. First and foremost, the state's current pension plans hide the price tag of benefit promises and allow costs to be pushed to future years indefinitely. Second, the pension plans have exposed the state to more risk than it has shown itself able to handle. Closing the funding gap is an important step, but reform would be incomplete if it did not also ensure that, going forward, Kentucky's pension plans do not experience unmanageable cost increases and accumulate unfunded liabilities that would threaten workers' benefits or the state's fiscal health.

Third, the traditional defined benefit plan currently offered by the state backloads benefits, meaning that employees earn most of their pension benefits late in their career. This creates an inherent inequity for short- and medium-term workers who are placed on a savings path that is unlikely to provide a secure retirement. The incentives in a traditional pension encourage workers to stay until they reach retirement age even if it might be preferable for them to change jobs, and such plans also provide an incentive for experienced workers to not work beyond their specified retirement age. As they shape reforms, state leaders must ensure that compensation packages help the state effectively recruit and retain a talented public-sector workforce.

A Framework for Reform

Pension reform is not easy. While Rhode Island's recent reforms demonstrate that dedicated policy makers can find solutions to serious pension problems, workers and retirees ultimately experienced real sacrifice and taxpayers remain on the hook for substantial contributions for decades. But what policy makers in Rhode Island and other states have realized is that delaying reform only makes their problems larger and more difficult to manage.

Kentucky's leaders should commit to comprehensive reform that will fix the state's pension problems once and for all. Additionally, any changes should honor benefits that already have been earned, as accrued benefits are legally protected. In the end, comprehensive pension reform must accomplish three goals:

1. Develop a plan to responsibly pay down the unfunded liability over a reasonable time frame. Ideally, the plan should not impinge on funding for services and the Commonwealth's overall economic viability.
2. Adopt a reformed retirement system that is affordable, sustainable, and secure. This system must ensure a secure retirement for workers and must reduce the potential for unforeseen cost increases or missed payments

that create future funding crises, threatening public employees and taxpayers. The reformed plan should reasonably guarantee full funding, so the state will not miss a payment even if costs rise.

3. Ensure that whatever plan the state offers enhances its ability to recruit and retain a talented public-sector workforce. Retirement savings are just one piece of total compensation, and policy makers must be thoughtful about how they allocate their limited dollars.

There is no one-size-fits-all solution. Every state has a unique set of policy preferences, political dynamics, and budgetary challenges. Real change requires hard choices, good information, and thoughtful analysis. The Pew Center on the States and the Laura and John Arnold Foundation stand ready to help Kentucky pursue real, comprehensive reform through our data and analysis on retirement systems, through help understanding the legal and actuarial issues surrounding public sector retirement systems, and through help in creating an effective and fair process for making these tough choices.

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