



Comments on Your Government

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RIPEC

State Pension Reform in Rhode Island

In October 2003, Governor Donald Carcieri initiated a process to evaluate the State's public pension plans and develop recommendations to ensure their long-term financial viability. The Governor established a 12-member review team made up of an equal number from labor and management, including RIPEC.

The Pension Review Team conducted an analysis of large public pension funds and collected and evaluated current and projected demographic information related to Rhode Island's pension system. The Team contracted with Gabriel, Roeder, Smith and Company (the firm currently serving as the actuary for the State's Retirement Board) to develop financial projections of the State's pension systems for both state employees and teachers. This projection provided information on the funding status of the system over a 20-year period as well as projected employer obligations. The Team directed the consultant to model various scenarios to test the impact changes to the pension system would have on the funding status of the system and the net cost/savings to the State and municipalities.

The following analysis reviews the findings and recommendations of the Governor's Pension Review Team, the Governor's proposed changes to the pension systems included in his FY 2006 Budget Request, and RIPEC comments and recommendations for next steps in pension reform.

Overview of Findings – Current Pension System:

- In FY 2006, Rhode Island's State and local governments will have to increase pension contributions to the State employee and teacher pension funds by \$89.5 million – a 45.0 percent increase from FY 2005.
- Combined, the two pension systems have nearly \$3.1 billion in unfunded liability (as of July 1, 2003). In other words, 35.0 percent of the liability is unfunded (\$3.1 billion of the \$8.7 billion in projected total liability).
- The State employee pension plan's overall funding status is projected to deteriorate from 71.7 percent funded in FY 2003 to 60.8 percent in FY 2005. It is projected to remain at this level through the end of the decade. The teacher pension plan's overall funding status is projected to deteriorate from 73.2 percent in FY 2003 to 60.3 percent in FY 2005, and will remain essentially unchanged through the balance of the decade.

- The Pension Review Team forwarded three proposals to the Governor;

Two proposals, (voted 6-6) called for establishing a minimum age to retire, changing the formula for calculating benefits and benchmarking the cost-of-living-adjustment (COLA) based on the consumer price index (CPI) capped at 3.0 percent. Depending on the proposal, these changes would apply to new hires, non-vested employees and/or those vested but not eligible to retire; and

The other proposal suggested further consideration of a range of revenue streams to increase the overall assets in the pension funds. While all 12 members agreed that this was necessary, RIPEC raised a number of questions regarding many of the potential revenue items, such as dedicating funds from gaming revenues.

- The Governor’s Proposal establishes a minimum age to retire at 60 with 30 years of service (65 with 10 years), changes the formula for calculating benefits (reducing the maximum benefit from 80 percent to 75 percent of average final compensation) and benchmarks the COLA based on the CPI capped at 3.0 percent. These changes would apply to new hires and non-vested employees.

RIPEC Comments and Recommendations:
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- RIPEC believes serious consideration should be given to the Governor’s proposal to establish a retirement age of 60 with 30 years of service, amend the formula for accruals for years of service, and limit the COLA to CPI capped at 3.0 percent. These changes would begin to address the impact the demands of the pension funds having on the State’s operating budget and provide relief at the local level.
- However, the Governor proposes to use all of the savings derived from the changes in employee pension benefits to balance the State’s operating budget. RIPEC believes that the proposed savings offer a unique opportunity to improve the health of the pension systems.
- Therefore, RIPEC suggests that the State consider a five-year program to shift the savings derived from the changes to the pension system from balancing the operating budget to improving the relative funding ratios of the pension funds. RIPEC estimates that the funding ratio for the State employee pension fund would improve to 87.0 percent by FY 2023 and to 85.2 percent for the teacher pension fund, compared to 81.5 percent under the Governor’s proposal.
- Finally, while the proposed use of surplus in excess of \$30.0 million warrants consideration, there are a number of practical questions as to how it would be administered, as well as fundamental fiscal policy issues to consider. There may be alternatives to address the unfunded liability issues facing the state pension systems.

Summary of Rhode Island's Current Pension System:

- As of July 1, 2004 the State employee pension system was 60.8 percent funded and the Teacher pension fund was 60.3 percent funded.
- State employees currently contribute 8.75 percent of their salary to the State pension fund, while teachers contribute 9.50 percent. Pensions are fully taxable.
- Employees must provide 28 years of public service in order to receive the normal pension benefits, regardless of age. Employees serve a minimum of 10 years to be vested in the pension system.
- Rhode Island applies an annual 3.0 percent COLA to pension benefits, beginning the COLA on the third January after retirement.
- Rhode Island determines the average final compensation (AFC) based on the highest three consecutive annual salaries.
- Approximately 18,500 people collect benefits today, and this is expected to increase to 22,600 by 2015 – while the number of people contributing to the system is expected to remain relatively static.

Calculating the Rhode Island Pension Benefit:

Rhode Island determines the average final compensation (AFC) based on the highest salaries of three consecutive years. Once this is calculated, the State uses a formula based on a certain percentage multiplied by an employee's total number of years of service, and then multiplies the product by the AFC.

Rhode Island does not have a single multiplier. It applies 1.7 percent to each of the first 10 years of service, 1.9 percent for each of the next ten years, 3.0 percent per year for each of the next fourteen years, and 2.0 percent for the 35th year.

Table 1			
Rhode Island Pension Benefit			
Employee with 30 Years Service			
Ave. Final Compensation:	\$50,000		
Pension Calculation	Percentage Factor	Years Served	Pension Benefit
First 10 Years	1.7%	10	\$8,500
Second 10 Years	1.9%	10	9,500
Third 10 Years	3.0%	10	15,000
Estimated Pension Benefit			\$33,000
<i>Percent of AFC:</i>			<i>66.0%</i>
Note: Maximum benefit in RI is 80% of AFC			
Source: RIPEC calculations based on RI Employee Handbook			

The maximum benefit is 80.0 percent of the employee's AFC. Therefore, if an employee worked for Rhode Island for 30 years and has an AFC of \$50,000, the calculation would look similar to Table 1. The employee would expect an annual pension of \$33,000.

Comparison of Large Public Pension Systems:

In comparing Rhode Island's pension systems, the Pension Review Team relied heavily on the National Education Association's *Characteristics of 100 Large Public Pension Plans* (June 2003). These data provided the most current comprehensive compilation of data to compare the key variables in public pension plans. The Study used valuations and data as of June 30, 2002.

- Seventy-five percent of the pension systems had a funded ratio of at least 80.0 percent as of June 30, 2002, as compared to Rhode Island's 77.9 percent.
- Rhode Island's pension system is characterized as having a relatively smaller number of years of service required to retire – of the 50 plans that provide retirement at any age, 35 required 30 or more years of service to retire.
- Of the 103 plans surveyed, 53 plans required employees to meet an age requirement. Rhode Island does not have an age requirement for retirement with full pension benefits. Rhode Island's pension plan is one of 10 of 103 plans surveyed that does not permit early retirement with a service discount.
- Seventy percent of the 103 surveyed pension plans have a vesting period of 5 years or less compared to Rhode Island's 10-year vesting requirement (twenty-two other pension systems require 10 years).
- Rhode Island employee contribution rates are among the highest in the Nation. Since Rhode Island state employees also participate in the Social Security System, the employee contribution rate of 8.75 percent is highest among plans that participate in Social Security and has a single plan rate.
- For formula multipliers, the most common was 2.0 to 2.2 percent of average final compensation per year of service. Rhode Island's multi-tiered rates tends to be back loaded in that the value of service increases as the employee provides more years of service (see Table 1 on previous page).
- Over half of the surveyed pension plans have ad hoc arrangements for calculating cost of living adjustments (COLA) rather than having an established fixed formula. As noted earlier, Rhode Island has a 3.0 percent COLA.
- Approximately 75 percent of the surveyed pension systems either partially or fully exempt pensions from State taxation. Rhode Island's pension is taxable.

Rhode Island Pension Demographics:

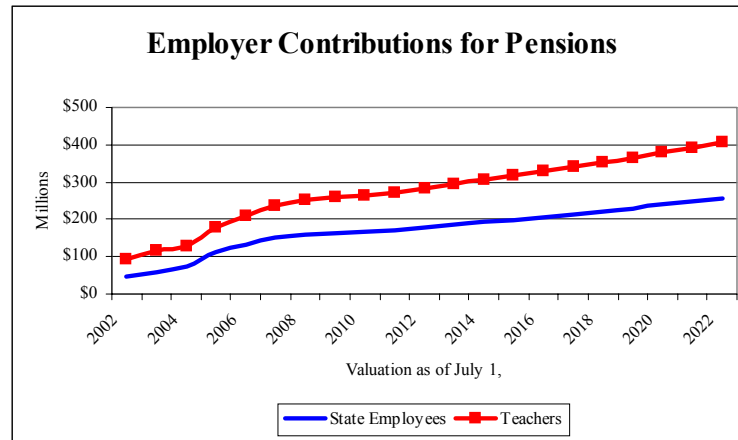
The Pension Review Team conducted an analysis of the State's existing pension system including understanding retiree and future retiree characteristics, such as age, average years of service, and average pension benefits. Trend analysis conducted by the State's Retirement Board staff looked at active employees, trends in active to retiree ratios, and evaluated actuarial assumptions and related methodologies.

- As of FY 2002, the State employee pension system had 13,795 active members and 9,426 retired members. In other words, there were 1.5 active members to every retiree. The average annual increase in active members is 1.0 percent while the average annual rate of growth for retirees is 1.5 percent.
- As of FY 2002, the teacher pension system had 14,710 active members and 7,311 retired members. In other words, there were 2.0 active members to every retiree. The average annual increase in active members is 2.9 percent while the average annual rate of growth for retirees is 5.7 percent.
- In 1993, State employees retiring with 28 years of service or more had an average age of 62. This has since declined to just under age 59 as of 2003.
- In 1993, teachers retiring with 28 years of service or more had an average age of just under 60. This has since declined to just under age 57 as of 2003.
- Average monthly pensions for State employees have increased from \$2,250 in 1993 to \$3,150 in 2003. Average monthly pensions for teachers have increased from \$2,500 in 1993 to \$3,750 in 2003 (unadjusted for inflation).

Establishing a Baseline for Modeling:

The consulting firm, Gabriel, Roeder, Smith and Company (GRS), prepared projections for the current pension system. The original baseline developed by GRS was based on values as of July 1, 2002. Gabriel, Roeder, Smith and Company recently revised the baseline to incorporate valuation data as of June 30, 2003, revised market experience, and other changes to assumptions that affected the projected employer contributions and forecasted unfunded liabilities. This revised baseline was used to compare different scenarios related to changes in the pension system.

The baseline for both State employees and teachers assumed a market return of 8.25 percent in FY 2005 and thereafter. This reflects current assumptions established by the State Retirement Board. The model incorporates actual market experience of 2.65 percent in FY 2003 and a projected market experience of 19.0 percent in FY 2004.



It is critical to understand that the baseline forecast was used to estimate the impact each change to the pension system would have on the employer contribution and the overall funding status of the pension fund. After this brief discussion of the baseline findings, it should be understood that the modeling discussion uses the FY 2005 employer contributions as its comparison point. The following highlights findings that reflect what is projected to occur should the State take no action to reform the pension systems.

- The FY 2005 employer contribution rate for State employees is 11.51 percent of compensation (estimated at \$628.8 million). This translates into an estimated contribution of \$72.4 million in FY 2005. The employer contribution rate for teachers is 14.84 percent of compensation (estimated at \$865.9 million). This translates into an estimated contribution of \$128.5 million in FY 2005.
- Projections show that the employer contribution rate for State employees would increase from 11.51 percent of salaries in FY 2005 to 21.63 percent in FY 2010. The employer contribution rate will peak at 21.90 percent in FY 2009 before leveling off at 21.10 percent thereafter.
- Projections show that the employer contribution rate for teachers would increase from 14.84 percent in FY 2005 to 24.89 percent in FY 2010. The employer contribution rate will peak at 25.19 percent in FY 2009.
- In FY 2006, the State will need to increase its contributions for State employees by \$38.3 million (from \$72.4 million to \$110.7 million due to the projected contribution rate increasing from 11.51 percent in FY 2005 to 16.96 percent in FY 2006).
- In FY 2006, State and local governments will need to increase the contribution for teacher pensions by \$51.2 million – from \$128.5 million to \$179.7 million (due to the projected contribution rate increasing from 14.84 percent in FY 2005 to 20.02 percent in FY 2006).

- Combined, the two pension systems have nearly \$3.1 billion in unfunded liability (as of July 1, 2003). In other words, 35.0 percent of the liability is unfunded (\$3.1 billion of the \$8.7 billion in projected total liability).
- The State employee pension plan's overall funding status is projected to deteriorate from 71.7 percent funded in FY 2003 to 56.7 percent by FY 2007. The funded ratio is not projected to return to FY 2003 levels until FY 2016. By FY 2023, it is projected to have a funded ratio of 83.4 percent given current assumptions.
- The teacher pension plan's overall funding status is projected to deteriorate from 73.2 percent funded in FY 2003 to 56.1 percent by FY 2007 before climbing back to 70.0 percent in FY 2016. By FY 2023, the teacher pension is projected to have a funded ratio of 84.0 percent given current assumptions.

Modeling Changes to the Pension System:

The Pension Review Team requested a series of models to determine what impact changes to the State's pension systems might have on projected contribution requirements, the funding status of the State employee and teacher retirement systems, and the benefits received by employees.

It should be noted that GRS updated the baseline's assumptions on both pension plans after the Governor's Pension Team had already completed its analysis of several different scenarios. The revised baseline incorporated valuation data as of June 30, 2003, revised market experience, and other changes to assumptions that affected the projected employer contributions and forecasted unfunded liabilities. The scenarios and their relative impact were predicated on older assumptions – however, the relative impact of the scenarios would not change significantly.

The major areas considered by the Team included vesting requirements, changes in the COLA, age and years of service requirements, and changes in the benefit formula. The consultant provided forecasts for each change in assumptions. The impacts were typically applied to either future hires or to future hires and those who were active but had less than five years of service (The Team considered 5-year vesting in the models).

The relative impact compared to the FY 2005 baseline employer contributions for State employees and teachers varied depending on the changes in assumptions. The Team explored different age and years of service requirements, as well as changes in the calculation of the formula for pension benefits. For example, several scenarios reflected changes to calculating the retirement benefit using different accruals for years of service. Table 2 displays the formula accrual models discussed and modeled for the Team. All three alternatives would reduce the maximum accrual for an employee from 80.0 percent under the current formula to 72.5 to 75.0 percent, depending on the model.

Table 2
Alternative Formulas for Benefits in the Employees' Retirement Systems of Rhode Island

Current		Model A		Model B		Model C	
Years of Service	Annual Accrual	Years of Service	Annual Accrual	Years of Service	Annual Accrual	Years of Service	Annual Accrual
First 10 (0-10)	1.70%	First 5 (0-5)	1.70%	First 5 (0-5)	1.70%	First 10 (0-10)	1.60%
Next 10 (10-20)	1.90%	Next 10 (5-15)	1.90%	Next 15 (5-20)	2.00%	Next 10 (10-20)	1.80%
Next 14 (20-34)	3.00%	Next 10 (15-25)	2.20%	Next 10 (20-30)	2.50%	Next 5 (20-25)	2.00%
35th Year	2.00%	Next 10 (25-35)	2.30%	Next 5 (30-35)	2.00%	Next 5 (25-30)	2.25%
						Thereafter (30-)	2.50%
Maximum Accrual	80.00%	Maximum Accrual	72.50%	Maximum Accrual	73.50%	Maximum Accrual	75.00%

In terms of age and years of service requirements, the Team reviewed proposals that considered age requirements of 55, 57 and 60, coupled with both 28 and 30 years of service required to receive full pension benefits. The consultant then provided models combining the changes in eligibility with changes in the benefit formula to provide more comprehensive alternatives to consider.

The Pension Review Team also explored the potential for Pension Obligation Bonds. While they could reduce employer contribution rates and increase each of the pension funded ratios, there would be the additional risk and exposure pension obligation bonds bring to the State as well as the additional debt service required to service the bonds.

Pension Review Team Recommendations:

The Pension Review Team agreed it was necessary to establish a process so that a group similar to the Pension Review Team meets every 3-5 years to evaluate the condition of the Pension Plans and to determine if additional actions were required to ensure its long-term financial health.

The Pension Review Team also forwarded three proposals to the Governor, two of which impact benefits (6-6 vote) and one that relies on identifying potential revenue streams (approved unanimously). The following highlights the proposals:

Proposal 1 – Proposal 1 would make several changes to the calculation of the pension benefit for future hires and those that are current but non-vested members of the pension systems (less than 10 years of service). The proposal would retain the requirement for members to serve 28 years to receive full benefits. However, the proposal would require members to achieve a retirement age of 57 as well. Those who have at least 10 years of service would be eligible to retire at age 65 (instead of 60). In addition, the Proposal would change the accrual formula as described in Table 3. The proposal also indexes the COLA to the CPI and capped at no greater than 3.0 percent.

Table 3

Proposal 1
Proposed Benefit Accrual Calculation

Years of Service	Proposal 1
Years 1-10	1.60%
Years 11-20	1.80%
Years 21-25	2.00%
Years 26-27	2.25%
Years 28-30	2.50%
Years 31-38	3.00%
Maximum Accrual	80.00%

The results translate into a projected cumulative savings in both pension systems of \$908.0 million, representing an average annual savings of approximately \$50.4 million over the 18-year period (FY 2005 – FY 2023). In FY 2006, this proposal would reduce employer contributions by \$36.3 million, of which \$11.0 million would come from the State Employee Plan and \$25.3 million from the Teacher Plan.

The proposal also includes a revenue initiative. The proposal would earmark 50.0 percent of any State year-end balance that exceeded \$30.0 million. In other words, \$0.50 of every \$1.00 the State has in surplus in excess of \$30.0 million would go to the State’s pension system. According to the proposal, a third would be allocated to the State Employee Fund, a third to the Teacher Fund, and the balance to deal with the State’s unfunded health care liability.

Proposal 2 – Proposal 2 would make several changes to the calculation of the pension benefit for future hires, those that are non-vested members of the pension systems (less than 10 years of service), and those who are active and vested but are not yet eligible to retire. For future hires and those who are non-vested, the proposal would retain the requirement for members to serve 28 years to receive full benefits.

Years of Service	Proposal 2
Years 1-10	1.60%
Years 11-20	1.80%
Years 21-25	2.00%
Years 26-30	2.25%
Years 31-37	2.50%
Years 38	2.25%
Maximum Accrual	75.00%

However, the proposal would require members to achieve a retirement age of age 55 as well. Those who have at least 10 years of service would be eligible to retire at age 60. In addition, the Proposal would change the accrual formula as described in Table 4 so that the maximum pension benefit would be 75.0 percent of salary after 38 years of service.

The proposal also instituted a change in the COLA in that the COLA would be indexed to the CPI and capped at no greater than 3.0 percent. This would apply to future hires, non vested employees and all those who are vested but not eligible to retire. This proposal would also require that 30.0 percent of the yearly net savings from the benefit changes would be used to pay down the unfunded liability of the pension system.

The results translate into a projected cumulative savings in both pension systems of \$1.0 billion, representing an average annual savings of approximately \$55.8 million over the 18-year period (FY 2005 – FY 2023). In FY 2006, this proposal would reduce employer contributions by \$40.0 million, of which \$14.0 million would come from the State Employee Plan and \$26.0 million from the Teacher Plan.

Proposal 3 – Proposal 3 did not suggest changes to pension benefits of future or currently active members of either pension plan. Rather, it outlined a series of potential revenue streams to inject into the pension plans to increase overall assets, thereby reducing the projected unfunded pension liabilities. These include, but are not limited to:

- *Fiscal Fitness Proposals* – Using the proceeds from the sale of State properties to buttress the State pension systems rather than permitting the resources to transfer to the State’s General Revenue Fund.
- *Gaming Revenues* – Dedicating net growth in State gaming revenues (using FY 2005 as a baseline) to the pension system. It was suggested that half of these funds could go to reduce the unfunded liability and the other half to reduce the Employer contribution.
- *Surplus Funding Proposal* – Earmarking surplus funds to reduce the pension liability. As outlined under proposal 1 above, the proposal would earmark 50.0 percent of any State end-year balance that exceeds \$30.0 million. In other words, \$0.50 of every \$1.00 the State has in surplus in excess of \$30.0 million would go to the State’s pension systems.
- *Capital Fund Accounts* – Redirecting funds from the State’s Sinking Fund (designed for debt relief) and the State Capital Fund to reduce the unfunded liability.
- *Municipal Pension Plans* – Exploring whether municipalities can redirect over-funded pension assets to teacher pensions to reduce the teacher unfunded liability.

While RIPEC supported the concept of reviewing these and other potential revenue streams to improve the condition of the pension plans, it raised a number of concerns regarding the impact these and other proposals may have on the long-term fiscal needs of the operating budget. For example, the Sinking Fund no longer receives resources from refinancing and other debt actions – it is now subject to annual appropriation. In addition, the State’s Capital Fund has been used as a counter-cyclical tool to either provide resources for debt service obligations during periods of fiscal stress or provide pay-as-you-go financing for capital improvements.

Administration Proposal:

The Governor has put forth a proposal in his FY 2006 Budget Request modeled after the analysis performed by the Pension Review Team. In short, the Governor proposes to establish a minimum age to retire at age 60 with 30 years of service (65 with 10 years), change the accrual formula for calculating benefits (the maximum benefit decreasing from 80 to 75 percent of AFC), and benchmark the COLA based on the CPI capped at 3.0 percent. These changes would apply to new hires and non-vested employees. The Governor has also proposed that any State surplus exceeding \$30.0 million would be used to reduce unfunded liabilities.

The proposal would translate into a projected cumulative savings for state and local government in both pension systems of \$1.3 billion, representing an average annual savings of approximately \$70.9 million over the 18-year period (FY 2005 – FY 2023).

The State would reduce contributions over this 18-year period by \$737.4 million. Municipalities would reduce contributions by \$538.6 million over this period of time.

In FY 2006, the proposal is projected to reduce employer contributions by \$50.9 million of which approximately \$29.4 million would be saved by the State (\$15.1 million in State employee contributions and \$14.3 million in State contributions to teacher retirement) and approximately \$21.5 million is projected to be saved by Rhode Island municipalities. The following explains the elements of the Governor’s proposal in greater detail:

- *Retirement Age* - As noted in this report, the current pension structure permits retirement at any age with 28 years of service and those with at least ten years can retire at age 60. The Governor has proposed that the minimum age for full benefits to be age 60, with 30 years of service, or age 65 with 10 years of service. These changes to eligibility for retirement would represent approximately 50.0 percent of the net savings in employer contributions.

- *Benefit Formula* - The Governor recommended that the rate at which employees accrue benefits change. The current pension system permits employees to receive a pension worth up to 80.0 percent of their final average final compensation (AFC) with 35 years of service. The Governor’s proposal would result in a maximum pension benefit of 75.0 percent of AFC after 38 years of service. This change would represent approximately 40.0 percent of the net savings in employer contributions.

Years of Service	Current	Proposed
Years 1-10	1.70%	1.60%
Years 11-20	1.90%	1.80%
Years 21-25	3.00%	2.00%
Years 26-30	3.00%	2.25%
Years 31-34	3.00%	2.50%
Year 35	2.00%	2.50%
Years 36-37	-	2.50%
Years 38	-	2.25%
Maximum Accrual	80.00%	75.00%

- *COLA* - The Governor has also proposed changing the cost-of-living-adjustment (COLA). Existing provisions of the pension system applies an annual 3.0 percent COLA. The Governor has proposed to link the COLA to the Federal CPI, capping it at no greater than 3.0 percent. This change to the COLA would represent approximately 10.0 percent of the net savings in employer contributions.
- *Surplus Funds* - The Governor has proposed to allocate any state surplus over \$30.0 million towards reducing pension fund liabilities. A third of the excess surplus would go to reduce the State employee unfunded pension liability, a third for the teacher pension fund and the balance to reduce the State’s retiree health unfunded liability.

While the changes would improve the State’s position relative to net total contributions to the system, the projected funded ratios would remain essentially unchanged. They actually get marginally worse over the 20-year projection. This is in part due to reductions in contributions as a result of the changes.

RIPEC Comments:

While there are several aspects of the pension system warranting attention, there are two that immediately emerge. First, the increasing costs of the two pension systems are major drivers of the growth in State spending. The immediate fiscal impact of the growth in the State and local contribution to these funds will make it increasingly difficult to control costs and target resources to other priorities.

If the system is not reformed, it is projected that employer contributions for both the State employee and teacher pension systems will increase by \$89.5 million from FY 2005 to FY 2006 – increasing from \$200.9 million in FY 2005 to \$290.4 million in FY 2006 (this represents a 45.0 percent increase over FY 2005 employer contributions). Of this amount, the State would have to provide approximately \$58.5 million and municipalities would provide the \$30.7 million balance.

In FY 2006, the State will need to increase its contributions for State employees by \$38.3 million (from \$72.4 million to \$110.7 million due to the projected contribution rate increasing from 11.51 percent in FY 2005 to 16.96 percent in FY 2006). State and local governments will need to increase the contribution for teacher pensions by \$51.2 million – from \$128.5 million to \$179.7 million (due to the projected contribution rate increasing from 14.84 percent in FY 2005 to 20.02 percent in FY 2006). Of the \$51.2 million in employer contributions for teacher pension costs, approximately \$20.5 million would be the responsibility of the State and the \$30.7 million balance would come from municipalities.

This creates a considerable restraint on the State and its local communities' abilities to direct resources to other pressing matters. Therefore, it is imperative that the State consider the pension reform proposals described above. The long term implications suggest that the demands of the pension system on the operating budget will become unaffordable.

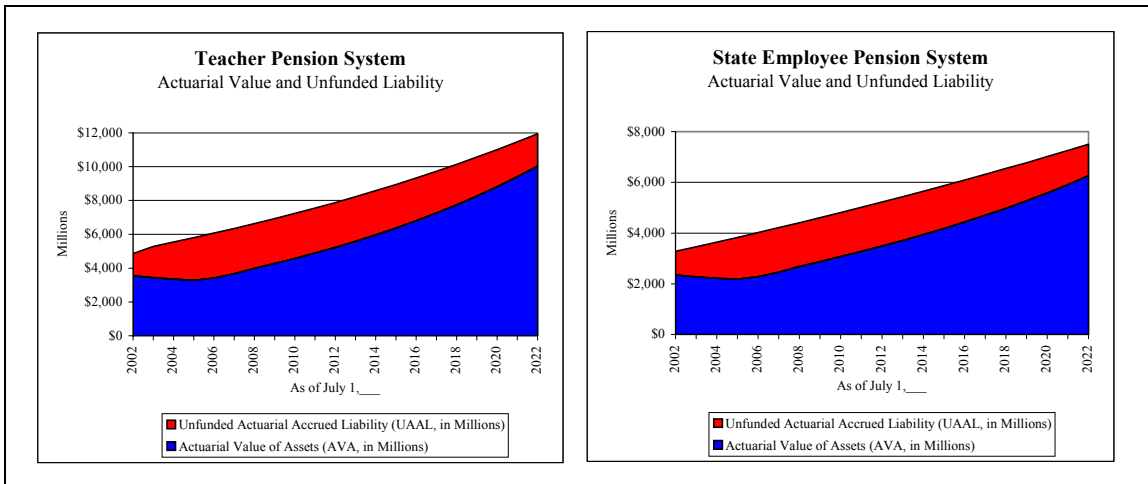
Second, the overall funding status of the funds should be of particular concern. Combined, the two pension systems have nearly \$3.1 billion in unfunded liability (as of July 1, 2003). In other words, combined, 65.0 percent of the fund assets cover its liabilities, or the inverse – 35.0 percent of the liability is unfunded (\$3.1 billion of the \$8.7 billion in projected total liability).

RIPEC believes serious consideration should be given to the Governor's proposal to establish a retirement age of 60 with 30 years of service, amending the formula for accruals for years of service and limiting the COLA to CPI capped at 3.0 percent. All these changes would not impact employees that are vested in the system, eligible to retire or those receiving benefits already. Their benefits would not change from this initiative and their retirement expectations would be met. However, these changes would begin to address the impact the pension fund is having on the State's operating budget and provide relief at the local level.

However, RIPEC raises concerns regarding two aspects of the Administration’s proposal:

1. To allocate State surplus funds in excess of \$30.0 million to reduce unfunded liabilities in the pension funds; and
2. To redirect all contribution savings derived from the changes in employee benefits to the State’s operating budget rather than using the savings to shore up the pension systems, thereby improving their overall funding status.

The Administration has proposed allocating State surplus funds in excess of \$30.0 million to reduce the unfunded liabilities in the State Employee Fund, the Teacher Fund, and the State’s unfunded health care liability. The proposed use of excess surplus funds might eventually improve the overall level of funding of the pension systems and may dampen the use of surplus funds to balance future budgets.



However, while the use of surplus in excess of \$30.0 million warrants consideration, there are a number of practical questions as to how it would be administered, as well as fundamental fiscal policy issues to consider. These include the need to ensure that the State has appropriate fiscal flexibility. For example, the State’s decision-makers might intentionally create a surplus for the coming fiscal year given existing options for available revenues to support programs and services. This was done when the State securitized the tobacco settlement resources.

The timing of establishing the surplus, how it interacts with revenue forecasting and what impacts it may have on the Governor’s annual operating budget development are all questions that would need clarification. Finally, given the proposal establishes a threshold of \$30.0 million, how does this threshold withstand the change in value of money? The value of \$30.0 million today will be significantly less relative to the budget in ten years. Should there be unforeseen fiscal issues facing the State, what provisions are there to ensure the State could access a surplus if it is available to deal with such a crisis? Would the State first tap resources from the rainy day fund or available surplus?

Second, RIPEC believes that while the changes to the pension system should help the State balance its FY 2006 budget, it does not fully take advantage of the opportunity to improve the financial health of the two pension systems. In other words, of the \$29.4 million in projected savings in FY 2006 to the State due to the proposed changes to the two pension funds, 100 percent of the savings are proposed to be used to balance the budget. None of these resources are being used to reduce the overall unfunded liability of either pension fund. It is proposed that this savings would continue to be used to balance the budget in subsequent fiscal years.

RIPEC believes that pension reform is needed and should be given a high priority given the increasing pressure such costs are placing on the operating budget as well as the impact growing unfunded liabilities may have on the State's overall credit worthiness. Redirecting proposed savings back into the pension funds would represent significant progress in lowering future costs while improving the overall financial health of the pension systems.

Therefore, RIPEC suggests that consideration be given to a five-year program to move the savings resulting from the pension benefit changes away from the operating budget and into the retirement funds to increase assets and to reduce the projected unfunded liability. Table 6 outlines a possible method of accomplishing this while meeting the immediate needs of the State's operating budget. The savings projected are based on Gabriel, Roeder, Smith and Company's data and RIPEC calculations. The table assumes that approximately 40.0 percent of the net savings in teacher pension contributions would accrue to the State given current contribution requirements. Given the difficulty of balancing the State's operating budget, a multi-year program to accomplish this goal seems reasonable.

Table 6
Proposed Method of Directing Contribution Reductions to Pension Assets
(\$ in Millions)

Fiscal Year	State	Savings Teacher	Teacher	State Total	Directed to Budget	Directed to Pension
2006	\$15.08	\$35.80	\$14.32	\$29.40	\$23.52	\$5.88
2007	15.66	37.15	14.86	30.51	18.31	12.21
2008	16.25	38.54	15.42	31.66	12.67	19.00
2009	16.86	39.99	16.00	32.86	6.57	26.28
2010	17.49	41.50	16.60	34.09	0.00	34.09
2011	18.15	43.05	17.22	35.37	0.00	35.37
2012	18.83	44.67	17.87	36.70	0.00	36.70
2013	19.54	46.33	18.53	38.07	0.00	38.07
2014	20.26	48.08	19.23	39.49	0.00	39.49
2015	21.02	49.88	19.95	40.97	0.00	40.97
2016	21.81	51.74	20.70	42.51	0.00	42.51
2017	22.63	53.68	21.47	44.10	0.00	44.10
2018	23.48	55.71	22.28	45.76	0.00	45.76
2019	24.36	57.80	23.12	47.48	0.00	47.48
2020	25.28	59.95	23.98	49.26	0.00	49.26
2021	26.23	62.22	24.89	51.12	0.00	51.12
2022	27.22	64.55	25.82	53.04	0.00	53.04
2023	28.22	66.95	26.78	55.00	0.00	55.00

Source: RIPEC Calculations based on Governor's Proposal and Gabriel, Roeder, Smith & Co.

RIPEC proposes to have an 80/20 distribution of the savings in year one, where 80 percent of the savings derived from the changes go to support the needs of the operating budget and 20 percent be allocated to the pension. Year two would have a 60/40 distribution, year three 40/60, year four a 20/80 distribution and year five and thereafter have the entire savings from the pension changes allocated to the pension system. There is no question that this will make it difficult for the State to meet its operating needs, but it will force the State to begin addressing the unfunded pension liability issues it currently faces.

If the changes to the pension system are implemented as proposed by the Governor, but the derived savings remain in the pension systems as proposed by RIPEC, RIPEC projects that the funded ratios for both plans would improve, with the State employee pension system 87.0 percent funded by FY 2023 and the teacher pension fund at 85.2 percent by FY 2023. This assumes that the savings would be allocated back into the pension funds where they were derived, that they would experience an 8.25 percent rate of return, and that there were no other changes to policy throughout the projection period.

The end result is that approximately \$676.3 million (92.0 percent) of the \$737.4 million in anticipated savings to the State from the changes in the pension would remain in the pension funds rather than directed to the State’s operating budget. The following graphs show the potential impact on the pension funds.

