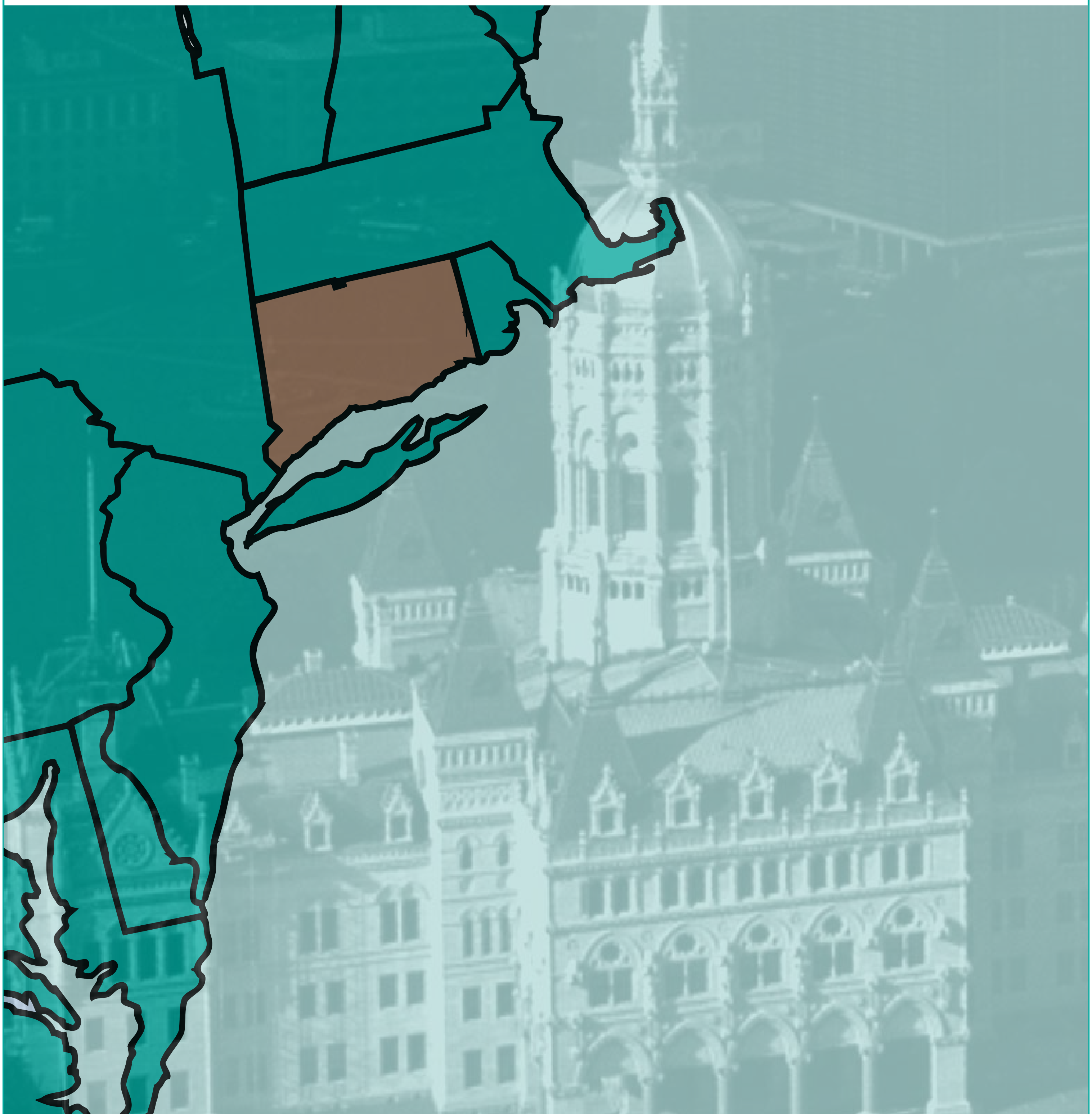
Framework for Connecticut's Fiscal Future

Part 3: Pensions and Other Post Employment Benefits: How Does Connecticut Compare?



A Report of the Connecticut Regional Institute for the 21st Century

The Connecticut Regional Institute for the 21st Century (the Institute) was formed in 1997 when public and private leaders in Connecticut came together to exchange ideas about increasing the state's economic growth by viewing Connecticut as part of a dynamic set of systems in the Northeast, not as a "stand-alone" political entity. The group focuses on educating policymakers on key issues that hold the most potential for the state's future. Managed by a statewide steering committee, the Institute is incorporated, has not-for-profit tax exempt status, and provides continuing opportunities to discuss and study important issues regarding Connecticut's competitiveness.

- In 1999, the Institute commissioned a significant study by the firm of Michael Gallis & Associates, Inc. entitled *Connecticut: Strategic Economic Framework*. The study defines the real-life economic markets and movement of people, goods, and ideas in the region, the nation and the world. That widely-recognized study is seen as a valuable policy framework, continuing to shape the Institute's initiatives.
- In 2003, the Institute turned to the issue of the link between Connecticut's future growth and responsible land use in order to draw connections between economic development, state and local planning, the trend toward sprawl, and preservation of our quality of life.
- In 2007, the Institute's report entitled *Economic Vitality & Competitive Cities* identified key features of successful cities and strategies for making all Connecticut communities attractive and productive, with recommendations for state and local actions to achieve this objective.

The Challenge of 2010

For the past two years the Institute has tracked the state's continuing battle to wrestle with the growing fiscal and economic crisis. The economic downturn has created increased need for public services while sharply reducing state revenues.

The numbers in Connecticut have dramatic implications for the role and costs of government at all levels:

- State budget deficits of $10 billion over the next three fiscal years, approximately 20% to 30% of the state's current services spending;
- Unemployment that is just around 9% and job recovery that is expected to be slow;
- Exploding numbers of foreclosures and personal bankruptcies;
- More than $41 billion in unfunded liabilities for retiree pension commitments and health obligations; and
- Cutbacks to local town and city governments that will cause deficits and potential sharp municipal tax increases.

Our state's elected leaders face difficult decisions as they seek to ensure that Connecticut emerges as a competitive, caring state as the economy improves. The massive federal stimulus package in aid and loans to our state and municipal governments will not solve our structural problems or fully close our vast deficit.

If the State does not deal effectively with the current structural fiscal issues, Connecticut's economic competitiveness is questionable. It is for this reason the Institute decided to take on a series of initiatives to assist the State in addressing the current fiscal and economic crisis.

The Institute's Current Mission

The Institute has resolved to look at elements of spending that account for a significant percentage of the state's budget and where shifts in approaches to service delivery could make a real difference. In doing so, the Institute reviewed major budgetary program areas to:

- Quantify savings that can be realized in the next fiscal cycle and over the long term;
- Identify opportunities to improve service;
- Identify opportunities to increase customer satisfaction; and
- Identify opportunities to increase efficiencies.

This resulting series of research studies is entitled *Framework for Connecticut's Fiscal Future*. The Institute's first study, focusing on Long Term Care, was released in March 2010. The second report, released in October 2010, examines Connecticut's Correction, Parole and Probation Systems.

This third report focuses on Pensions and Other Post Employment Benefits and how states, including Connecticut, are facing the funding crisis.

For further information about the Institute and its work, visit www.CTRegionalInstitute.org.

Fiscal Context of Pensions and Other Post Employment Benefits (OPEB)

Connecticut, like many states, faces the worst fiscal crisis in a generation. The State projects facing a $3.4 billion budget deficit in fiscal year 2011. Shrinking revenues are forcing governors and legislators to examine all areas of public spending for possible savings. This report focuses on the funding crisis for pensions and other post employment benefits that is facing many states but is particularly burdensome in Connecticut.

Since the 2008 financial meltdown, the tension between the fiscal health of the states' retirement programs and the need for states to provide other services has been especially intense. Between 2008 and 2010, in an effort to get costs under control, 40 states took at least one action with respect to their pension programs, and 15 states took at least one action with respect to their retiree medical program.

Pension and OPEB liability represent a fiscal tsunami heading right for Connecticut. Increasingly towns and states are actually considering bankruptcy because of the huge liability associated with pensions and OPEB. Connecticut's unfunded pension and medical liability is $41.878 billion. This represents a liability of $17,480 for every voting age citizen in Connecticut. Our total annual required contribution (ARC) to the pension and medical plans is $2.968 billion per year. This represents 12% of Connecticut's current annual state budget.

Connecticut has lagged the 49 other states in terms of number and magnitude of actions taken to address its unfunded liability problem.

Connecticut's Pension and OPEB benefits

The State of Connecticut provides a defined benefit pension plan and a retiree health plan for its employees as collectively bargained by the Connecticut State Employees Retirement System (SERS). In addition, state employees participate in Social Security for which the state contributes 7.65% of an employee's compensation (6.2% for OASDI and 1.45% for Medicare). The State of Connecticut also provides teachers with a defined benefit plan (Connecticut Teachers' Retirement System); however, members do not participate in Social Security or Medicare. The Teacher's Plan is funded by local boards of education. A defined benefit pension plan is a retirement program that provides a monthly benefit to its participants at retirement. In addition, the plan may provide its participants death benefits and disability benefits.

Benefits are generally related to the amount of time a member participates in the plan (i.e., years of service) and the member's compensation. With additional service and progressively higher compensation, a participant's pension benefits will increase over time. Social Security benefits will also increase with time in the system.

Although the state's retirement eligibility rules do not match up exactly with Social Security, it is expected that the combination of the two programs will provide an adequate benefit to a retired career employee.

Summary of Report Findings

Our first step in undertaking this study was to examine the various actions taken by all 50 states in the last two and a half years to address their retirement plan funding challenges. The purpose of the analysis was both to document the types of actions being taken and to identify any connection between the condition of each state's retirement plan and the actions taken.

Most frequently states either raised the employee contribution rates or adjusted the employer's contribution. Even with employer contribution adjustments, many states still did not pay the entire ARC because of their overarching budgetary pressures. Some states were only paying reported retiree medical benefits each year and will phase-in contributions to fund the retiree medical program beyond current benefits.

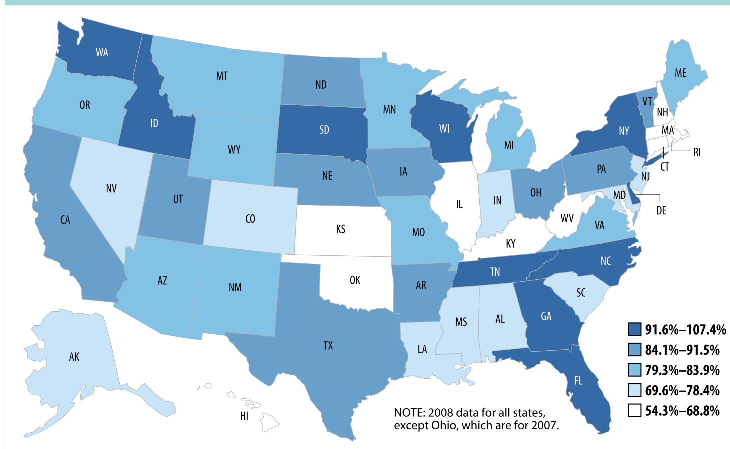
States also focused on abuses within their respective systems. Most of these actions related to either compensation or re-employment rules. The most common compensation action was changing the averaging period on which retirement benefits are calculated. Typically the change was from a three-year to a five-year average compensation calculation. Some states instituted limits on the amount of a compensation increase in a single year that could be included in the average. This was done to eliminate compensation "spiking" where some employees deliberately boost their salary, and thus their retirement benefits, by working large amounts of paid overtime in the years immediately preceding retirement.

Other cost reducing measures included raising the normal retirement age, changing the early retirement eligibility or benefit reduction rates, and lowering cost of living adjustments (COLAs) for future retirees and in a few cases, current retirees. In the case of both Colorado and Minnesota, COLA adjustments were across-the-board and lawsuits have been filed in each state to block the actions.

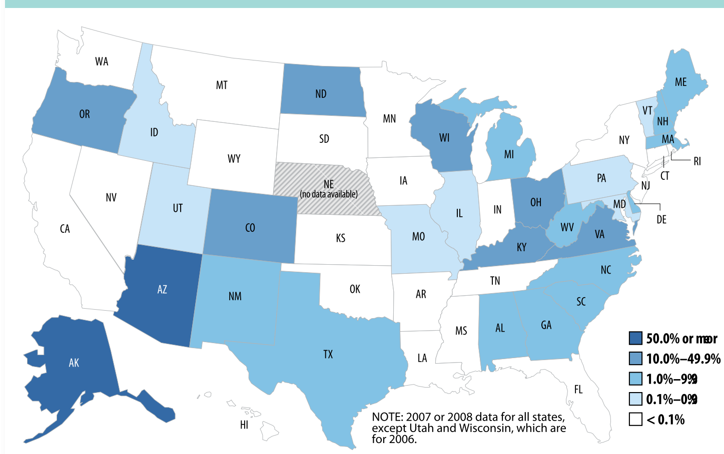
Ten states implemented retirement incentive programs (RIP) as a means to reduce overall employment costs. Because of these incentives, the unfunded liabilities for either the pension or the retiree medical plans increased. A RIP often utilizes the pension program for a non-retirement goal, with the justification being lower long-term overall employment costs for the state. In order to avoid revolving door employment (where recently incented retired employees return to work), some states modified their re-employment rules to prevent such actions.

Pew Center for the States report - *State Pensions and Retiree Health Benefits: The Trillion Dollar Gap*

STATE PENSION FUNDING LEVELS



STATE RETIREE HEALTH CARE AND OTHER NON-PENSION BENEFITS



A critical issue is whether future benefits for all employees can be changed prospectively. Some states are constitutionally prohibited from modifying their existing benefit programs. Other states, such as Michigan and Hawaii, follow the ERISA type rules that govern private sector plans, and protect only benefits that have accrued as of the date of the plan change. All future benefits for all employees can be changed prospectively. Connecticut has chosen to grandfather future benefits for current employees and has created the tiered benefit structure that currently exists consistent with this policy. While these benefits are statutorily protected, there is no constitutional prohibition to modifying future benefits in Connecticut. Prospective changes to benefits already negotiated are likely to be challenged, as is currently the case in Minnesota and Colorado. But it is difficult to ignore this huge part of our unfunded liability.

Connecticut's ARC requirement is the third highest in the country when measured as a percent of total state expenditures, and yet only two cost reduction actions have been taken. (The state implemented a retirement incentive plan to reduce the size of the state workforce, and required new employees to contribute 3% of their pay for the first 10 years of service.)

Given the funding status of its plans, Connecticut has lagged behind other states in the number and magnitude of actions to reduce costs associated with both the retiree medical and the pension plans. Connecticut's ARC as a percent of expenditures is one of the highest in the United States; yet the number of actions it has taken to control costs is one of the lowest.

Number of Actions Taken by Type - All States

Pension Plans	Actions	Retiree Medical Plans	Actions
Eligibility	6	Eligibility	5
Compensation	12	Subsidy	4
Benefits Cap	3	Service	1
Multiplier	10	Vesting	1
Service	5	Employer Funding	5
Vesting	5	Employer Contributions	6
Early Retirement	12	Other	1
Normal Retirement	12	Retirement Incentive Program	4
Cost of Living Adjustments	13		
Pension Obligation Bond	2		
Employer Funding	17		
Employer Contributions	16		
Retirement Incentive Program	10		
Re-employment Rules	16		
Disability	3		
Other	3		
Hybrid	6		
Total Actions – Pensions	**151**	**Total Actions – Retiree Medical**	**27**

Recommendations

Considering the fiscal crisis faced by Connecticut, and the lack of action to curb pension and OPEB liability, Connecticut must use all means at our disposal to reduce our liability while maintaining a fair level of benefits to Connecticut state retirees and current employees. It is this balance between current employees, and their potential benefits and former employees that is so difficult. Nonetheless the Institute believes there is much to learn from other states' actions over the past two and a half years and recommends that the Governor and the Legislature review them all and take strong action on numerous fronts to get this problem under control.

The state and municipalities should design comprehensive compensation plans, including both salaries and benefits, sufficient to attract and retain employees qualified to deliver state and municipal services. On a regular basis, the plans should be analyzed relative to those available for comparable private sector employment both on a plan feature to plan feature and on a total compensation to total compensation basis. This would introduce the following changes:

Programmatic changes to reduce costs:

- Increase the age at which employees are eligible to retire with full benefits
- Change the averaging period on which retirement benefits are calculated from three to five years and eliminate pension spiking by not counting overtime
- Provide early retirement benefits that are actuarially equivalent on a current market basis to a member's normal retirement benefit payable at the member's normal retirement age
- Do not offer retirement incentive plans
- Following the example set by Michigan and Hawaii, eliminate benefit structure guarantees based on date of hire in favor of guarantees based on ERISA-type rules whereby only vested accrued benefits earned-to-date are guaranteed
- Delay medical coverage for early retirees and beneficiaries until an employee reaches a specific age (such as 62) even if vested and eligible
- Eliminate COLAS and Longevity Payments
- Implement a Hybrid or Defined Contribution plan effective immediately for all new employees
- Use the "Rule of 90" to determine qualification for retirement with full benefits
- Require employee and retiree contributions to the cost of medical coverage
- Implement managed care and wellness programs

Changes to accurately reflect liability and remedy underfunding:

- Adopt GAAP accounting as a state
- Require the state and municipalities to make the full ARC payment determined by its actuaries in accordance with accepted actuarial principles annually, based on third party actuarial calculations
- Decrease assumed rates of return and inflation to reflect more realistic and conservative expectations about the economy
- Fund all currently unfunded pension liabilities within 15 years without using approaches that backload amortization costs
- Eliminate the reductions in ARC payments negotiated in SEBAC IV and V

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CONNECTICUT REGIONAL INSTITUTE FOR THE 21ST CENTURY

The Connecticut Regional Institute for the 21st Century provides continuing opportunities for its members and other organizations to understand and discuss economic activity in the state and obstacles to its success. For more information, visit www.ctregionalinstitute.org.