**Solving the Pension Cost Problem with Real Structural Reforms**  2/28/21 Cynthia Browning

The costs of Vermont’s pension systems are again spiraling out of control. These costs are taking up a larger and larger percent of the budget and the education fund, and the unfunded liabilities are a larger and larger percent of state debt. This has already lessened our ability to provide services and to make needed investments for Vermonters, which makes it harder for our economy to grow enough to generate tax revenue to be able to pay for pensions.

This is a longstanding problem and it is past time for the Vermont legislature to truly face reality and reform these systems, to protect the security of the pensions of many Vermonters and for the sake of Vermonters as a whole who pay taxes and need services and investments. For this fiscal year it looks like tax revenues will actually be up due to the impact of a massive injection of federal spending. But when that funding passes, the cost of the retirement systems as currently structured will likely continue to rise uncontrollably. These costs of the state employees’ and teachers pension systems rise continually due to the nature of the systems, due to state mismanagement, and due to developing conditions that were not incorporated into the original cost estimates. The beneficiaries of these systems deserve the reality of secure pensions with costs covered rather than the illusion of benefits based on risky assumptions. Only real and lasting structural reforms can give them this, and prevent the cycle of crises and the threat of insolvency that undermines the state’s ability to serve Vermonters as a whole.

**Both Risky Structure and Irresponsible Mismanagement**

These pensions are defined benefit systems. This means that certain benefit levels are defined that must be provided. The benefits are financed with contributions from employees and from the employer, but if there is any shortfall in those funds it is entirely the responsibility of the state as the employer to make up the difference and pay the benefits. The defined benefit structure means that these costs are not under the control of the state, they are determined by the provisions of the system and how unfolding conditions affect costs. The state commitment to these systems imposed significant risks on taxpayers for the funding of the defined benefits, and they should have been conservatively managed in terms of setting contributions by employees and the state. They were not.

With defined benefit systems the employer can pay for all benefits due in a particular year from that year’s budget, or money can be put aside in a dedicated fund ahead of time that will generate investment returns over time and then pay out the benefits when they are due. Paying as you go is very risky, because there may be years when revenues are down and it is hard to make the payments, and costs can go up. Pre-funding requires a lot of discipline to save for the future needs. However, the interest earned over the years of invested pension funds can be very significant in accumulating the needed future financing. Vermont’s pension systems are intended to be pre-funded as much as possible.

For these systems expert actuaries calculate how much should be put into a pension fund every year in order to be able to finance future benefits. The actuaries base these estimates on the terms of the benefits, the number of future beneficiaries, their salaries at retirement, and their life expectancies, along with expected financial returns on the investment of any cumulative funds invested. If sufficient funds are not available when benefits are due the cost must be covered in that year’s state budget.

Two key measures are the Funded Ratio that shows what percent of the funding needed for the future is on hand, and the annual Actuarially Determined Employer Contribution (ADEC) amount required to achieve and sustain that funding given the beneficiary contributions. The state employees and teachers contribute certain fixed amounts and the state makes contributions as settled during the budget process, which need to be close to the ADEC to have the best chance to achieve full pre-funding for the future needs.

As time passes and conditions unfold the actuaries can change their estimates of the level of contributions required for pre-funding. This has happened repeatedly to the state systems, so that it turns out that the benefits promised will now cost much more than originally estimated. These changing estimates are the key cause of our current difficulties. The original assumptions that formed the foundation of the cost estimates for these systems did not match the realities that unfolded – they turned out to be incorrect. Those original over optimistic assumptions made it politically easier to commit to the systems, but it was a very large assumption of risk by the state on behalf of the taxpayers, and now we see the consequences of the mismanagement of that risk.

First, the state has sometimes failed to pay into the system the amount needed to build towards full funding. Most of these recent partial payments of the ADEC were back in the 1990s, and the Funded Ratios then were actually relatively high.

Second, the benefits promised in this system have been generous. My understanding is that at least twice in the early 2000s benefits were increased with no associated increase in either employee or employer contributions, which is irresponsible.

Third, the actual rate of return on the invested pension funds has usually been lower than that assumed in the cost estimates. The calculation of how much money will be needed to make payments in the future includes that estimate of how much the invested funds will earn. When the actuaries belatedly recognized that actual returns are trailing what was assumed, they adjusted their estimate of the money needed for full funding upwards, because the invested returns won’t add to the accumulated funds as much as expected.

Fourth, the actuaries have repeatedly had to increase their estimates of cost due to rising compensation levels at retirement and longer beneficiaries’ life expectancy. This means that without any change in the benefits levels or the beneficiary population the expected future cost of retirement benefits gets bigger. This factor has had a significant impact given the large fraction of the beneficiaries in the Baby Boomer demographic cohort.

Given that this is a defined benefit system, all extra cost from these developments falls on Vermont taxpayers unless reforms are put in place.

Twice in the past 14 years the actuarial revisions referred to above have led to large increases in estimated costs and required payments. As recently as 2007 the State Employees Funded Ratio was estimated at 100% and the Teachers’ Funded Ratio was at 85%, which are both pretty solid. Then in 2008 the actuarial re-estimate was done and in 2009 the Funded Ratios were 79% and 65% respectively, and the required state ADEC payments therefore got a lot larger. This upwards cost estimate reflected the lower rate of return and the higher compensation and extended longevity of beneficiaries, and it meant that more money will be needed to have enough to pay future benefits. After extensive negotiations benefits for State Employees and Teachers were reduced slightly and their contributions were increased, and the state began to make the larger ADEC payments every year, sometimes even making more than the required payment in order to make more progress towards funding. The employees and the state deserve great credit for making such difficult changes, but it turns out it was not enough to prevent the same thing from happening again because of the internal dynamics of this system.

Because now in 2020 the new re-estimate puts the funded ratios lowered to SE 66% and T 51%. This was again primarily due to the lower rate of return and the increasing compensation and longevity of the beneficiaries. This increase in estimated costs came after over a decade of the state making over 100% of the ADEC payments. The changes in 2008 were supposed to put us on a path to have full system funding in 2038, but we are now even further behind. The costs keep rising for the same benefits. These systems are not sustainable for taxpayers and they are not secure for beneficiaries. Given the competing demands on the state budget, it is unlikely that the state can pay in enough to pre-fund and then paying benefits from the annual budget would also be difficult.

And even, worse, this kind of actuarial increase in expected costs can happen yet again, and it most likely will.

We are now in a situation where there will be another process of negotiation to see what reforms can be done to the systems and how much the state can increase payments. The position of the employee beneficiaries is extremely important, because their retirement benefits cannot legally be altered without their consent. They can sue if retirement benefits are so altered unless there are some level of exigent financial circumstances for the employer. It would be safer for beneficiaries to face reality again, in 2020 as in 2008, negotiate lasting reforms that will provide for secure pensions without damaging the state’s ability to provide for them. They will have to pay a larger share of the cost of reduced benefits, but the most reliable way to be sure of any benefit is to pay for most of it yourself. The illusion of higher benefits that may still be based on unrealistic assumptions will likely be shattered by future insolvency. This is a disservice to the state employees and teachers who have worked so hard for us. They deserve a reliable retirement, rather than an ephemeral illusion. The beneficiaries need to see that the costs of the current pension systems may actually be preventing the state from making the investments that could grow our economy enough to enable the state to generate the revenue to cover the retirement costs. The need to see that Vermonters have paid in way more to finance these systems than the original cost estimates. How long can this go on?

**Real, Permanent Solution or Another Illusory, Temporary Fix?**

The State Treasurer Beth Pearce has acknowledged that the current system is headed towards insolvency because the cost outstrips the state’s ability to pay. She recommends reducing benefits and increasing both beneficiary and state contributions to lessen the possibility of insolvency. It is my understanding that her recommendations would keep the state’s contributions about where they are now, which is still quite high.

She also suggests allocating any state budget surplus or part of any forthcoming Federal Funds to the pension pre-funding.

Governor Scott has urged others to make reform proposals and is willing to entertain the Treasurer’s suggestions. The Legislature has formed a working group to look at all possibilities. The state employee and teacher leaders have so far rejected the Treasurer’s proposals and suggest increasing taxes on high income Vermonters.

I could support the Treasurer’s proposal but it does not go far enough, because there is nothing to prevent another cycle of actuarial re-estimation and cost increase. That is the key element that is missing from her suggestions that would be essential to truly making these systems sustainable. A mechanism must be put in place by statute that requires automatic changes in benefits and employee contributions when the actuaries lower the Funded Ratios, increasing the unfunded liabilities and increasing the ADEC. In other words, whenever that re-calculation is done the greater cost must AUTOMATICALLY be paid by employees and/or benefits must be reduced. The growth in the state’s share must be firmly capped. If the state employees and teachers want the designated benefits, they must pay more for them. The taxpayers have paid in way more than the costs originally estimated.

Since any or all of these changes will be politically difficult, I would make continued higher state payments of ADEC or extra allocations of budget surpluses or Federal Funds conditional on such changes. The beneficiaries must collaborate to create lasting structural reforms if they expect further support from taxpayers.

In terms of the employees’ proposal of increasing income tax rates on high income Vermonters, I am not necessarily averse to the idea of increasing state income tax rates on high income folks for some purposes. I didn’t think it was a good idea to reduce the rates in the upper brackets by as much as we did several years ago. But to propose increasing such tax rates without the beneficiaries also contributing doesn’t seem balanced, and there would be many other competing uses for any such added revenue.

If and only if sufficient lasting structural reforms are blocked by the beneficiaries, I would also propose the imposition of a temporary low targeted income tax surcharges on active employee beneficiaries and retired beneficiaries of these pensions that would be used to fund the system from which they benefit. These taxes could progressive, a low percent at lower levels of income and higher at higher levels of income. The tax would ONLY be on the beneficiaries of the state employee and teacher pension systems, and the revenue would go right back in to support their own systems. The surcharge would cease when the Funded Ratio rises permanently – when the cycle of rising cost estimates ceases.

As things now stand, I don’t expect that reforms of the retirement systems will actually be implemented due to the political power of the beneficiaries. Maybe just a watered down version of the Treasurer’s proposals. I believe that the state will use any budget surplus or extra Federal Funds to pay down the exploding liabilities without really facing or fixing the dynamic structural flaw in the system. Then in five or ten years we will have another crisis as the system comes closer to insolvency again when reality does not match actuarial assumptions Since all of these changes will be politically difficult, I would make continued state payments of ADEC or extra allocations of budget surpluses or Federal Funds conditional on such changes.

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