# Legislative Options to Achieve Public Retirement Plan Reforms

By Girard Miller

*State legislatures face mounting pressures to further reform public retirement plans to achieve sustainable, sufficient and competitive levels. A major legal challenge facing many states is their ability to change benefits for current employees. This article reviews both legal and pragmatic issues, and offers specific options, policies and strategies to guide legislative reforms.*

Following the stock market swoon of 2008–09 which decimated pension fund investment portfolios and doubled the unfunded liabilities of most public plans, the funding problems of public retirement plans has attracted national attention. With public pension plans now underfunded by about $800 billion using conventional actuarial methods applied to 2010 year-end market values, and public retiree medical benefit plans suffering even deeper deficits of $1.5 to $2 trillion, concerns are mounting over the ability of public employers to meet their obligations. Pension reform has become a rallying cry in many state legislatures, and many states have revised their plans in an effort to address the financial hemorrhages.

The challenge now facing states and localities is that many of the revisions and reforms enacted thus far are still insufficient to align long-term liabilities and costs with the capacity of public employers to pay for these benefits. And for those that have failed to act, the hole keeps getting deeper even though the stock market has rallied handsomely from its 2009 trough. Hence, further rounds of retirement plan reform legislation likely will be necessary in the coming year(s). In some states, taxpayer and watchdog groups are preparing possible ballot initiatives, so the pressure is mounting to take action for both political and economic reasons.

This article will first provide legislators and policy analysts with criteria to consider when revising laws governing public retirement systems. Then it summarizes some of the key legal issues facing legislators seeking to change benefits for retirees and current employees in many states. Finally, in light of these considerations and limitations, it offers suggestions and guidelines for the most efficient forms of pension and retirement benefit plan reform.

## Criteria for Retirement Reform

For a public employees' retirement plan or system to operate in the best interests of all stakeholders, including taxpayer-voters as well as the affected employees, it must be affordable, sustainable, sufficient and competitive. Affordable means the employer and the employee must be able to make this year's contributions for proper actuarial funding without extreme sacrifices.

Sustainable means the plan must be designed so that it remains affordable every year into the foreseeable future without reducing public services or employment levels, and each generation pays for the costs associated with the public services it receives. For public employers, this means the total costs to fund the plan actuarially *during the lifetimes of current employees* are within the financial capacity of the sponsoring government. A sustainable plan does not kick the can to future generations to bear the costs of benefits earned by public servants who retired before these younger taxpayers became adults.

Finally, the plan must be sufficient to attract and retain qualified public employees in a competitive labor market in light of their total compensation. When we discuss various options to restructure retirement benefits in order to control costs, we must remain mindful that the benefits must be sufficient to remain competitive in the open labor markets. However, legislative policy should focus on the entire labor markets from which public employees are recruited, and not just the public sector employment categories that are often used in labor arbitration or personnel comparisons. For example, competitive recruitment of firefighters should include an explicit reference to the trades from which such employees are commonly recruited, and not just other fire departments, so that the total compensation of the public employees, including their retirement benefits, do not exceed what similar workers could obtain in competing job markets at the time of recruitment as well as after they have become trained and skilled. Otherwise, competitive compensation standards in the public sector will become a circular exercise that lacks foundation in the real economy. This is a key complaint of public managers who often find their labor costs controlled by state laws that ignore the private sector labor markets and sometimes even use out-of-state public sector comparisons for professions in which employees are never recruited from out-of-state.

## How to Change Retirement Benefits Prospectively

Generally, state and federal laws protect the rights of public employees and retirees to receive pensions they were promised to receive for past service. For retirees, this usually means the basic pension they now receive is immutable. Cost-of-living allowances may be subject to revision, depending on state law, but most policy analysts and attorneys would agree retirees are the most protected class under law, since they typically have no way to regain employment status and expand their retirement benefits. In the middle of this spectrum are retiree medical benefits, as many states can declare that such benefits enjoy less protection, if any, should they choose. Texas, for example, has declared retiree medical benefits are a gratuity and employees enjoy no contractual rights to receive such benefits if the employer fails to appropriate funds for such a benefit or declines to enter into a contractual guarantee. At the other extreme, there is near-universal agreement that subject to collective bargaining where applicable, the retirement benefits of future employees can be changed at will by the employer because such employees will accept the new benefits structure as a term of employment when hired. For incumbent employees, however, the laws defining and governing vested rights are heterogeneous and much murkier.

For current employees, there is general agreement that the private-sector standards of the federal Employee Retirement Income Security Act—known as ERISA—which protect the accrued vested rights of employees, should also apply in the public sector. This means employees cannot be forced to accept a retirement benefit of less than what they now are legally entitled to receive for their prior service. What is not so clear, however, is how each state's laws will control the rights of public employees to the continuation of benefits formulas they presently enjoy. This is the "prospective benefits problem" in state and local government. In some states, the state constitution or the courts have established a theory of law that employees—once hired—are entitled to a continuation of benefits formulas in place at the time of hire or plan change, even for service provided in the future. Such employees are not only vested for their past service, they can become immediately vested in the benefits formula that benefits them the most. Herein lies the rub.

Generally, the standard for impairment of contract should be that the actuarial value of previously earned retirement benefits cannot be reduced. No public employee should be forced to work in the future for "negative benefits." But public employees' "entitlement" to continue current benefits formulas will be hotly contested in the legislatures of many states in the coming years. In California, a state legislative advisory commission has formally recommended that state law be changed to permit prospective changes in retirement benefits accruals in order to preserve the overall system.[1] For a complete copy of the Little Hoover Commission report, see *http://www.lhc.ca.gov/studies/204/report204.html*.

At issue are the nature of the constitutional promise, if any, and the contractual rights of public employees even under emergency financial conditions that imperil the financial capacity of the retirement plan to deliver its promised benefits.

## Fundamentals of Pension Law

Starting with the state constitutional law issues, the best single source of recent legal research on this topic is the work of Minnesota law professor Amy Monahan, whose 2010 study of state laws regarding vested pension rights is a must-read for any pension reformer and legislator seeking to comprehend this subject.[2] She identifies a dozen states in which the state laws grant incumbent employees some form of protection or at least a claim to continue their current benefits formulas. That said, an emerging body of legal analysis based on case law has found that public employees' contractual rights can be impaired, even under federal law, if (1) the changes in the plan on a prospective basis are necessary to preserve the plan's capacity to pay benefits on a sustainable basis, (2) the benefits reductions do not exceed the minimum amount of change necessary to preserve the plan, and (3) the employer still provides a reasonable retirement benefit (i.e., both sufficient for its intended purpose and competitive in the labor markets).

## Saving the System

This "crack in the wall" of contractual rights under federal law is an important development that will ultimately be decided in federal courts. The law here is clearly unsettled and cases are pending in Colorado, South Dakota and Maryland that could ultimately result in new precedents—especially after appeals. Meanwhile, lawyers for taxpayer and watchdog groups are evaluating the concept of emergency suspension of pension accrual rights of incumbent employees. Just what would trigger or signify an emergency is yet to be determined. It could be a legislative declaration based on specific findings of fact, which clearly falls within the authority of most state legislatures, or it could be a constitutional standard imposed by a referendum or ballot initiative.

For example, a pension fund or retiree medical benefits plan—known as OPEB or other post-employment benefits—with an actuarial funding ratio below 79 percent providing benefits to an employer that is failing to make all its actuarially required contributions might be declared to constitute an emergency condition that warrants making prospective benefits formula reductions and raising the retirement age for that employer's workers. Even under such emergency conditions, however, most experts would caution against actions that impair or diminish actuarially the accrued vested benefits of employees and retirees if at all possible, as those would be the benefits most likely to be protected in the courts as well in the theater of public opinion.

Even if the stock market recovers further in the coming years, which would drive the funding ratios of many pension plans above the suggested 79 percent funding threshold, the underfunding problems of OPEB (retiree medical) plans will persist for at least a decade because most of them presently hold no assets. Thus, an employer and its employees could escape emergency restructuring of the pension plan, but still face an emergency requiring plan redesign for the OPEB benefit. In fact, that would be the most likely scenario in many jurisdictions.

In this context, here are the reforms legislatures most likely will consider in an effort to provide authority for public employers to change benefits formulas prospectively for incumbent employees:

**1. Raise employee contributions.** This is generally the least controversial as a matter of law. Benefits may enjoy protections, but employees' contributions are fair game for legislative reform. A strong argument can be made that employees are more responsible in their views of the benefits when they share in the costs and do not view the retirement benefits as "free money." In some cases, the laws might provide that public employees should pay half the "normal" actuarial cost (for current service) and perhaps also a portion of the cost of unfunded liabilities for benefits they themselves have received—especially if those benefits were increased and awarded retroactively. For retiree medical benefits plans (OPEB), the concept of an employee contribution is relatively new, but will become inevitable in many states because these plans are quite deeply and unsustainably underfunded. Over time, the author expects to see a majority of public employers require their employees to either contribute to the OPEB plan or to opt out into an alternative, lower-cost benefit.

**2. Reduce pension multipliers prospectively.** Here, the idea is that future service will be rewarded with a lower benefit formula. For example, a state may limit the maximum multiplier for future service to 1.7 percent for general employees and 2.3 percent for public safety employees in the Social Security system, and 2.5 percent for those outside of Social Security. Such benefit levels would be consistent with "sufficient" pension benefits for new hires, and would put senior employees on an equal footing with new employees with respect to their future service. Such reductions, where they apply, will also have a significant impact in reducing employer costs.

**3. Raise the retirement age for younger workers.** It is not fair to raise retirement ages for workers over age 50 by more than a month or two for each year prior to their planned retirement, but for younger workers, it may be both appropriate and necessary to invoke higher ages ranging from 62 to 67 for civilians and 57 for public safety. Legislatures can consider a variety of transition provisions to provide equitable treatment to in-service employees. As explained previously, a prudent provision for changes of retirement ages would be a provision that any employee whose retirement date has been increased prospectively should not suffer a reduction in the accrued actuarial value of previously earned vested benefits; this adjustment can be made on an individual basis and would optimize the plan transition by giving the plan and the employer the greatest latitude for making changes while still protecting individual rights. For example, a plan now allowing retirement at age 55 could be changed to age 65 as described above, with the caveat that a senior employee with accrued vested rights may retire before age 65 if the result would otherwise be a reduction in the worker's already accrued benefits.

**4. Prohibit retroactive pension increases.** History has shown that benefits increases awarded retroactively have produced no value to taxpayers, a windfall to the senior incumbents and huge liabilities for the employers.

**5. Raise retiree medical benefits (OPEB) eligibility ages.** For new hires, age 65 will likely become the new norm for employer-paid retiree medical benefits. For incumbent employees, age 60 for civilians and age 57 for public safety are appropriate and reasonable levels with appropriate transition provisions to protect vested accrued rights. For example, a transition formula could cap the benefits of incumbent employees by a ratio of (a) their years served, divided by (b) either 25 or 30 years as a normal full service career. Again, the rule that accrued vested benefits should not be reduced may apply here if the plan documents and enabling legislation have provided legal claims to full benefits at an early age. Some states and employers are likely to eventually require incumbent employees to contribute at a higher rate if their OPEB benefits begin before age 65.

**6. Limit retiree medical benefits** to a fixed dollar per month per year of service. A formula allowing $10 or $15 per month per year of service, toward retiree medical expenses, will still be highly competitive in the private labor markets. A Consumer Price Index inflation escalator can be provided, but this will be far less costly than medical inflation.

**7. Require employers to make full actuarial contributions** by a certain date. In the interim, those presently underfunding must ramp up their contributions. For OPEB plans, this may take five years.

**8. Place a dollar cap on pension benefits** or pensionable compensation at a level not to exceed two times the state's median household income (presently $50,000 nationally). This would essentially limit public pensions for new hires to five figures on average, and compel those seeking higher retirement income to also participate in a defined contribution (401a, 403b or 457) plan. Illinois set the limit at $106,800 for new hires last year.

**9. Require hybrid** defined contribution and defined benefit plan for new hires similar to the federal employees' retirement system, or FERS, which provides a pension multiplier of 1 percent and a matched employee savings plan up to 5 percent of salary. Washington state has operated a similar hybrid plan for several years.

**10. Limit total compensation to competitive market standards.** Some states will likely consider the establishment of statutory limits on total compensation for public employees to prohibit the award of retirement benefits that would exceed private labor market standards when combined with salaries, wages and other benefits. Such a standard would still permit retirement benefits to exceed private sector standards.

**11. Other miscellaneous reforms** should also be considered, such as "anti-spiking" provisions that eliminate overtime from pension calculations, require a longer average final compensation calculation (e.g., three or five years), elimination of deferred retirement option (DROP) plans, which have rewarded employees for unsustainable early retirements, institution of mandatory or optional defined contribution plans or hybrids for new employees, and governance of the retirement plans to include more, or a majority of, independent disinterested directors.

A key issue in some states will be whether these limits supersede collective bargaining or supplant it. This issue is hotly debated in some states as this article goes to press, and the author makes no definitive recommendation. However, it would seem reasonable for the legislature to set limits by statute that cannot be exceeded in a labor agreement, and permit bargaining within that envelope of restrictions. This assures retirement reform on a universal statewide basis to discourage piecemeal reform efforts, wide and noncompetitive disparities in benefits among public employees, and divide-and-conquer tactics by multiple employee bargaining units.

## Conclusion

Legislators are coming to realize that the easiest changes to make—the reduction of benefits or the establishment of a defined contribution plan for new hires—are unlikely to accomplish much in the way of financial savings in the near time, because skyrocketing retirement plan costs will force most public employers to freeze or even reduce their work forces in order to scrape together their required actuarial contributions. So although such reforms are important for both symbolic and long-term reasons, the real challenge in the coming year or two will be the extent to which each legislature is able to install cost-mitigation laws that would produce immediate and long-term savings by revising the prospective benefits structures of current employees. The ground is clearly shifting in this direction, but we won't know where it settles until the courts make some landmark decisions.

Meanwhile, many states will have no choice but to enact reforms that are necessary, equitable and reasonable, and hope that the superior courts will uphold their best efforts to rebalance a nationwide system of public employee retirement plans that now faces the greatest financial challenge in its history. The litmus test for many such reforms will be whether they preserve current employees' vested accrued rights for benefits earned by prior service, while enabling the employers to prospectively reduce their compensation costs to sustainable levels for future service.

## Notes

[1] Little Hoover Commission, California Legislature, Public Pensions for Retirement Security, Report 204, (February 2011). For a complete copy of the Little Hoover Commission report, see *http://www.lhc.ca.gov/studies/204/report204.html*.

[2] Amy Monahan, Public Pension Plan Reform: The Legal Framework (March 17, 2010); Minnesota Legal Studies Research No. 10-13).

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