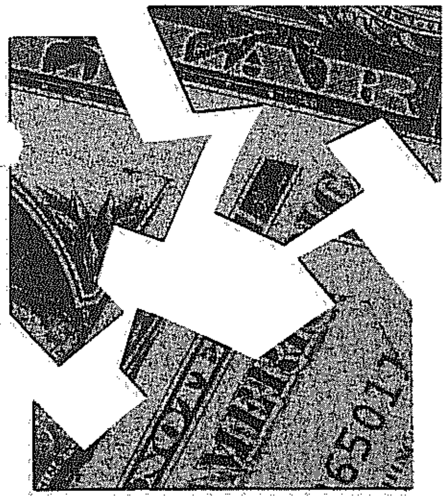

PAR SPECIAL REPORT #3

Financing Louisiana's Future

PUBLIC AFFAIRS RESEARCH COUNCIL OF LA., INC.

May 1987

Public Retirement: The Check Is in the Mail?

Louisiana must completely redesign its approach to providing for public employee retirement if it is to avoid major fiscal problems in the future. A single system, under public control, is needed to administer the retirement program equitably and efficiently for all state and local government employees. Eligibility requirements and benefits must be redefined to return to the original purpose of retirement—that of providing an adequate replacement income for full career employees at the end of their working years. Most importantly, the system must be placed on a sound funding basis to ensure money is available to pay future retirees and to protect future taxpayers.

The Problem

Thirty-nine public retirement systems operate under Louisiana state law. These include four state-funded systems, nine statewide systems for local employees, and 26 separate local systems. These differ widely in the method and adequacy of funding, eligibility, level of benefits, administrative efficiency and investment performance.

Chronic underfunding of three of the four state-funded systems has created a growing unfunded accrued liability (UAL) now over $5 billion. This UAL has contributed to the state's lower bond rating and poses a long-term threat to the state's fiscal health.

The high UAL levels resulted from the state's failure over many years to provide the proper level of employer and employee contributions as determined by the systems' actuaries. Increasingly liberal benefits, granted without corresponding funding, raised the cost of retirement and the size of the liabilities while passing that cost on to future taxpayers.

The largest of the state-funded systems—for teachers—is in serious trouble. The system, according to one actuarial forecast, could exhaust its assets (now $2.5 billion) within 20 years if current trends continue. A smaller system—for state police—will use up its assets within three or four years. The state general fund will have to

History of Unfunded Accrued Liabilities of State and Statewide Retirement Systems

System(s)	1980	1981	1982	1983	1984	1985	1986
State Funded (4)	$2959.8	$4,055.5	$4,361.8	$4,373.1	$4,150.5	$4,328.6	$4,862.7
Statewide (9)	233.9	281.3	294.2	361.8	330.3	484.0	628.8
Total (13)	$3,193.8	$4,336.7	$4,656.0	$4,734.9	$4,480.8	$4,812.6	$5,491.5
te Employees'	$1,257.9	$1,431.7	$1,559.9	$1,598.5	$1,421.4	$1,509.1	$1,493.4
Teachers'	1,493.3	2,416.1	2,575.3	2,556.5	2,540.3	2,621.5	3,016.7
2 System Total	$2,751.2	3,847.8	$4,135.2	$4,155.0	$3,961.7	$4,130.6	$4,510.1

NOTE: Data as of June 30.
SOURCE: Legislative Auditor, *1986 Annual Report on State and Statewide Public Retirement Systems of the State of Louisiana*, April 1987.

pay retirees' checks when the systems deplete their monies. Within 30 years, the state could be paying retired teachers $2.7 billion a year in benefit checks directly from the general fund if recent trends continue.

Trends Shaping Retirement Issues

If adequate retirement benefits are to be provided at a cost taxpayers are willing to pay, policy changes must be made now to deal not only with current problems but to prevent potential problems 25 and 30 years away. Current national trends point to the need for retirement system redesign:

- A sharp rise in the number of persons reaching age 65 will occur in 25 years as the baby boom generation ages.
- Decreasing mortality rates at older ages increase the life expectancy of those over 65.
- People will be in better health and better able to work in their 60s and 70s.
- The ratio of working to nonworking persons will decline sharply without a change in working-age patterns.
- The federal government has been encouraging a shift to greater personal responsibility for retirement (although the recent federal tax reform act provides mixed signals).
- All state and local government employees will likely be brought under social security participation. (Most Louisiana public employees presently are not covered by social security.)
- Medical costs will likely continue to rise.
- Inflation may be higher and productivity gains lower than historically.

Several current conditions that could continue to affect Louisiana retirement systems for some time include:

- a decline in the growth of public employment which slows the growth in contributions;
- severe fiscal pressure on state and local governments which reduces potential contributions and has resulted in incentives to encourage early retirement, and
- lower interest rates which result in lower investment earnings compared with recent years.

Comprehensive vs. Piecemeal Reform

Over the years, a host of recommendations regarding specific aspects of public retirement—normal retirement age, cost-of-living adjustments, the definition of average compensation, accrued annual and sick leave, and early retirement—have been offered by PAR, other private groups, legislative committees and study commissions, legislative actuaries past and present, the systems themselves, a few concerned legislators and a governor's cost control commission.

Important reforms can and have been achieved on a piecemeal basis but the more meaningful reforms, in terms of putting public retirement on a sound fiscal basis for the long run, have not received the attention they deserve. Correcting the current problems requires major funding changes and reduction of overly generous benefit packages.

The disparate retirement systems, benefit packages and funding levels reflect a piecemeal, unplanned and often illogical development process. At the heart of this problem is the absence of clear goals and purposes of the public retirement programs. Benefits have been granted, not to meet public policy objectives, but rather in response to increasing employee demands.

Contributing to the problem is the technical complexity of both the pension plans and the actuarial methods used in their operations. Few legislators have had the time or inclination to gain an adequate understanding of pensions and their funding. Only in recent years has the Legislature had expert assistance in estimating the impact of proposed changes, but this technical advice often has been misunderstood, mistrusted or simply ignored.

A myriad of issues must be settled in the process of structuring an adequate program of public employee retirement that can be financed by the state and local governments. Many of these issues involve highly technical considerations of specific benefits requiring a great deal of actuarial and pension planning expertise. A concerted effort and assistance from professional pension experts is needed to provide the comprehensive solution that is required.

Piecemeal reform of the retirement systems is proving slow and uncertain. A comprehensive restructuring into a single consolidated retirement program would permit all aspects of retirement to be considered at once and in relation to each other. The new plan could take trends into account and provide for future contingencies such as the likelihood of mandated social security coverage.

Major Policy Decisions Needed

The state must make a number of very basic policy decisions concerning its public retirement programs. The remainder of this report presents major policy recommendations concerning:

- reform mechanism
- purpose
- funding
- management structure
- uniformity.

Recommendation

A permanent public employee retirement commission should be created to prepare a proposed consolidated retirement system for public employees and to conduct annual reviews of retirement issues.

A comprehensive examination of Louisiana's retirement programs and the design of a replacement system could be undertaken in three ways: by contract with an independent consulting firm, by a joint legislative committee on retirement, or by a special study commission. Contracting would be quite expensive and the results could be suspect. The joint legislative committee's perspective might be somewhat narrower than that of a properly constituted special commission.

A special retirement study commission was created in 1985 to examine a wide range of retirement issues. While it recommended a number of reforms that were subsequently enacted, the commission makeup was dominated by representatives of the retirement systems and it postponed many of the tougher issues. The commission was not continued.

The proposed commission should include the chairmen or representatives of the legislative committees on retirement, finance and appropriations; two private sector members with actuarial, pension management or insurance experience (appointed by the Speaker of the House and President of the Senate); the state treasurer; attorney general; the commissioner of administration; and no more than three members representing the public retirement systems (one each for the state-funded, statewide and hazardous duty groups).

Staffing for the commission should be provided by the Division of Actuarial Review in the Legislative Auditor's Office with assistance from the retirement committees' staff. Additional funding for the auditor's office (a minimum of $50,000) should be provided for limited contract consulting work or temporary expert assistance under the supervision of the legislative actuary.

The proposed comprehensive revision should be completed prior to the 1988 regular legislative session.

Recommendation

The primary purpose of public employee retirement should be to provide an adequate replacement income, when considered with other resources available, for full career employees who have reached the end of their productive worklives because of age or disability.

The original purpose of public retirement systems was to provide a secure source of income for employees when they reached the end of their productive worklife. The formulas rewarded longer service but did not attempt to fully replace working income and assumed the retiree would have savings and could get by on a reduced standard of living. Additional purposes were to offer protection for permanently and totally disabled employees and survivors of deceased employees and retirees.

Over the years, the original purpose was drastically changed and new purposes added as employees sought and received additional benefits. Often the new "purposes" were merely rationalizations for more liberal benefits, while the consequences of those changes were ignored or unrecognized.

Some of the purposes added over the years include:

- compensating for public salary scales generally lower than the private sector;
- rewarding a substantial public career (25 to 30 years) without regard to an individual's ability to continue working productively;
- providing an escape valve for teachers unwilling to teach in an integrated school system (more recently the purpose has been restated as serving as an escape valve for "teacher burnout" and providing a special inducement to enter the teaching profession);
- compensating employees for prior military service and accrued sick and annual leave without a direct agency expenditure;
- ensuring a youthful staff in public safety occupations, and
- providing additional compensation to elected officials in both part-time and full-time positions.

The early retirement provisions and other special benefits have taken retirement programs far beyond their original purpose and at a significant cost. Prior PAR reports have recommended reforms in a number of the basic eligibility and benefit provisions of various systems.

- The normal retirement age should be set at 65 with a minimum of 10 years' service or at any age with 40 years' service.
- Early retirement should be permitted at age 55 with 10 years' service but with the retiree's benefits actuarially reduced.
- The normal retirement age for hazardous duty employees might be set lower than 65 but not less than 55 with 10 years' service. Benefits should not be paid such employees prior to reaching age 55.
- With the possible exception of hazardous duty employees, no individual or group should receive special benefits.
- Full-time elected officials should be governed by the same provisions as other members.
- Part-time elected officials should be prohibited from joining publicly-supported retirement systems.
- Members should not be allowed to acquire credit for service as part-time elected officials.
- Retirement credit for accrued annual or sick leave should be terminated.

These reforms would not only restore the original purpose to public retirement, but also reduce its cost and recognize current economic and demographic realities.

Recommendation

The state constitution should be amended to ensure that any public employee retirement system is maintained on a sound actuarial basis. This provision should require that: a uniform actuarial method be selected, annual contributions be sufficient to cover normal costs, unfunded liabilities be amortized over time, and no action be taken that would impair the actuarial funding condition of the system.

An actuarial (prefunding) approach to financing retirement is demonstrably superior to a pay-as-you-go approach. Yet, while the state has accepted the actuarial approach in principle, it has fallen far short of implementing the concept.

An actuarial funding method aims to accumulate assets during an employee's working career which, together with investment earnings, will be sufficient to pay all of his benefits when he retires. The cost of retirement is thus recognized and paid at the time the employee's services are being used, and investment earnings help pay the benefits. When costs related to earlier years of service are added to the system—as when the system is initially created or benefits are increased and extended to prior years' service—those costs generally are paid off (amortized) over 30 years or longer (federal law requires 30 years for private plans).

Funding Levels of Louisiana State and Statewide Retirement Systems, 1986[a]

System(s)	Percent Funded[b]
State Funded (4)	49.98%
State Employees'	53.46
Teachers'	44.90
School Employees'	71.43
State Police	8.24
Statewide (9)	63.61
Total (13)	51.23%

a Data as of June 30.
b Funded ratio=assets/accrued liabilities.
SOURCE: Legislative Auditor, *1986 Annual Report on State and Statewide Public Retirement Systems of the State of Louisiana*, April 1987.

The four state-financed systems and all nine statewide retirement systems were intended to be actuarially funded. Two unfunded systems (LSU and judges) are being phased out. However, only one system (registrar of voters) is fully funded, another (state police) is on the verge of pay-as-you-go, and the rest fall somewhere in between.

Combined, the 13 systems have about half the assets needed to be considered fully funded with the statewide systems doing somewhat better than the state-financed ones.

In 1986, the 13 systems had \$11.3 billion in accrued liability (the present value of promised future benefits) and \$5.8 billion in assets, leaving \$5.5 billion in unfunded accrued liability (UAL). If a system receives only enough contributions each year to cover the normal costs (covering the benefits earned that year) the UAL, which is the missing amount of money which should be invested and earning interest, will grow by the amount of the interest earning foregone. This is approximately what has happened in the state systems.

A large UAL is not necessarily a problem. Not doing something about it, however, could mean a serious problem for future generations of Louisianians. Paying off the entire UAL at once is neither feasible nor necessary. The important thing is to select a time period over which to pay it off, adopt an actuarially sound method of payment and then stick to the plan.

Other states have used periods of 30 to 100 years to amortize the UAL of their systems. Several methods may be used including a level percentage of pay method and a level dollar amount approach. The latter method is preferred by the legislative actuary, although it would require larger payments in the earlier years. The percentage of pay method requires larger payments in later years but in the process, the UAL would be permitted to double (the ear payments would not fully cover the interest) before a reduction in principal began.

Using the level dollar method, the legislative actuary finds that \$377.1 million a year in contributions would be needed for 30 years to pay off the UAL of the four state-funded systems. This amount plus the \$343.2 million needed to cover the normal costs for fiscal 1986-87 would total \$720.2 million. In contrast, these systems are expected to receive only \$514.5 million.

Regardless of the amortization approach adopted, it is essential that the Legislature provide the required contributions as determined by the actuary. In the past, the state treated the employer contributions as a budget-balancing tool and generally set the contribution rate independent of and lower than that recommended by the system actuaries. In spite this failure, the Legislature continued to add benefits which further increased the UAL and closed its eyes to independent actions by the systems which did the same.

Cost-of-living adjustments (COLAs), granted by the Legislature or by the system boards, have often been improperly funded and misused. The proposed constitutional amendment would correct the funding problem but not the problem of misuse. PAR has previously recommended that actuarial studies be undertaken to determine the options and costs of providing a properly limited automatic COLA. Further, PAR has suggested that no COLA be given to a retiree who has not reached the age of 65 and been retired for at least one full year.

While experts may argue the fine points as to what constitu a sound actuarial basis for funding a retirement system, several basic elements are clear. A system should receive sufficient funds to cover the normal costs of retirement benefits earned during the year and the cost of amortizing ıy existing unfunded accrued liability over some fixed period. Further, a change in benefits which increases the liability of a system should not be permitted without a corresponding funding arrangement designed to cover the additional cost. With these three funding policy elements in place, a retirement system would always be approaching full funding even though it might be far from reaching the goal for many years.

The constitution presently declares membership in a public retirement system to be a contractual agreement between the employer and employee and further requires the state to guarantee benefits payable to a member or retiree of a system for state or school employees. The constitution is silent as to how such systems are to be funded or how such benefit payments are to be made.

The recommended constitutional amendment would balance the benefit guarantee with a guarantee that the necessary funds are put up to pay for them. This amendment would not only require the proper level of contributions but also would nip in the bud any future increases in benefits which could not be funded. Furthermore, it would give added impetus to cutting overly generous benefits as a way to reduce contribution requirements.

Recommendation

All of the state-funded and statewide retirement systems should be consolidated into one system with optional inclusion of the individual local systems. A single policy board should be created with a majority comprised of public members with 'evant expertise. The board ..ould select a professional chief executive to administer the system.

The multiplicity of systems results in administrative inefficiencies, plans devised to serve special interest groups, opportunities for benefit leapfrogging, and inequities in the treatment of different types of public employees. A major problem is that the management responsibility is turned over to the system members and the public is largely denied the ability to supervise and control the disparate systems.

Since 1970, three basic trends have been evident regarding the management of the public retirement systems. Legislation has provided increased consolidation of systems, greater uniformity in plan provisions across systems, and improved state oversight of the system operations. While significant advances have been made in each of these three areas, a genuine resolve to press these trends to their logical conclusion still is not apparent.

The 13 state and statewide systems, although organized within the Department of the Treasury, still operate as nearly independent agencies. The treasurer has only limited supervisory authority. The system boards are composed almost entirely of system members or retirees and the few ad hoc members assigned to provide an outside viewpoint are themselves members of public retirement systems. A system's financial accounts are audited, not by the legislative auditor, but by a CPA firm hired by the system's board.

The primary external supervision of the systems has been by the legislative retirement committees. The Office of Legislative Actuary, created in 1973, has played an increasingly important role. For example, the actuary recently used authority granted in 1984 to require all 13 systems to make their reports following the same basic actuarial method.

Full consolidation of administration is possible. Six states have single systems covering most state and local employees. One system may administer several plans.

The experience in other states offers several basic approaches to administering a consolidated system. For example, the system could be administered as a government agency with a director appointed by the governor and without a management board; or the separate corporate identity approach could be retained but with a policy board revamped to provide public control (e. g., a five-member board including the state treasurer, two public members with relevant expertise appointed by the governor and the legislative leadership, a representative of the active members and a representative of the retired members).

The important thing is that the largest share of retirement system funding comes from the taxpayer, and the public—not the membership of the retirement system—should control the administration of the system.

Recommendation

New tier plans should be developed and applied as broadly as possible to all state and local public employees, including new employees, current employees whose benefits are not yet vested, and to the future service of current employees who are vested in benefits earned to this point.

Total uniformity of eligibility and benefit provisions is not possible because some employees are currently covered by social security, thus requiring a separate subplan to coordinate retirement and social security benefits. This subplan should be carefully designed to serve also as the replacement plan for other employees should social security coverage become mandatory.

A potential second subplan in the new tier system would be for hazardous duty employees. This subplan might incorporate a slightly lower normal age for retirement and perhaps some other benefit differences.

The provisions in the main new tier plan should apply uniformly to the subplans in all respects except those specific and limited areas of difference for which the subplans are designed.

Achieving uniformity has often been a ploy to upgrade benefits to meet the highest given to one of the systems. Uniformity should be achieved by first determining the acceptable level of benefits and then bringing everyone in line. Uniformity is easy to achieve in a second tier plan for new employees. More difficult is achieving greater uniformity in benefits for active members of the current plans. The Legislature should not shrink from reducing benefits for current employees where necessary. A case might be made for protecting rights to benefits already earned and vested, but the Legislature should reject the argument that benefits to be earned with future service are somehow a contract obligation. The state has no obligation to continue the salary schedule at present levels or even to continue the jobs of employees. It is difficult to see how the state should have a greater obligation regarding unearned retirement benefits, particularly those given to one class of individuals and not to others.

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Financing Louisiana's Future
PAR Special Project

Six months ago, PAR undertook a study of major issues of long-term importance critical to Louisiana's governmental and economic future. A series of reports analyzing these issues and providing specific solutions to problems is now being prepared for release. This report, "Public Retirement: The Check is in the Mail?", is the third of the series. Additional reports will be forthcoming.

In 1987 citizens will decide on the state's new policymakers—the governor, other state officials and legislators. It is imperative that the candidates address these essential issues and solutions so that they can be judged by their stance on them. Statewide discussions and active debate over these issues will have a significant impact on our future.