RESET
LOUISIANA'S FUTURE

Pension Reform

Louisiana should improve the state pension system to reduce the risk of increasing debt, better serve the state's workforce recruitment needs and provide a more competitive system for employees.

Transform State Retirement Systems for a New Era

Louisiana's state retirement systems are underfunded at levels well below the national average and even further below measures of sound financial health. The state's policies and practices exacerbate the debt problem and the risk to taxpayers while offering uncompetitive and inadequate plans for most employees. The current situation has a negative impact on government and teacher workforce recruitment and salaries.

The state's four retirement systems have a total debt, or Unfunded Accrued Liability (UAL), of just over $18 billion[i]. The UAL is the gap between how much the retirement systems need to pay promised benefits minus any assets of the systems such as investments in stocks and bonds. The two largest state retirement systems have only 62% to 64% of the funds needed to meet their long-term obligations to retirees[ii]. Only 13 states have a worse level[iii]. Louisiana ranks ninth in pension debt as a percentage of government worker and teacher payroll[iv].

Through taxpayer dollars and fees, the state and school districts are responsible for meeting these debts. Colleges, responsible for contributing $260 million toward retirement debt this year, rely primarily on state support and tuition. Employees and teachers contribute a percentage of their pay toward retirement plans but are not responsible for the unfunded liabilities. Louisiana's debt payments – now at nearly $2 billion annually – eat into other priorities such as education, healthcare and public safety, not to mention the prospect of substantive increases in employee and teacher salaries.

The Official UAL

Officially, the four state retirement systems combined have unfunded accrued liabilities greater than $18 billion, although the Louisiana Legislative Auditor cautions that the real UAL is probably $4 billion higher.

Teachers (TRSL)	$10.6 billion
State Employees (LASERS)	$6.7 billion
School Employees (LASERS)	$664 million
State Police	$288 million
Total	$18.25 billion

How did the debt manage to get so large and what can be done? Most Louisiana government workers and teachers are enrolled in a defined benefit plan, in which employees receive a guaranteed monthly income for the rest of their lives after they retire. The income is based on a formula that includes the number of an employee's years of service and the average salary of the employee's highest-earning years, which are usually the last few years before retirement. The formula – not the amount of money set aside or available in the retirement system investment portfolio – determines the guaranteed benefits.

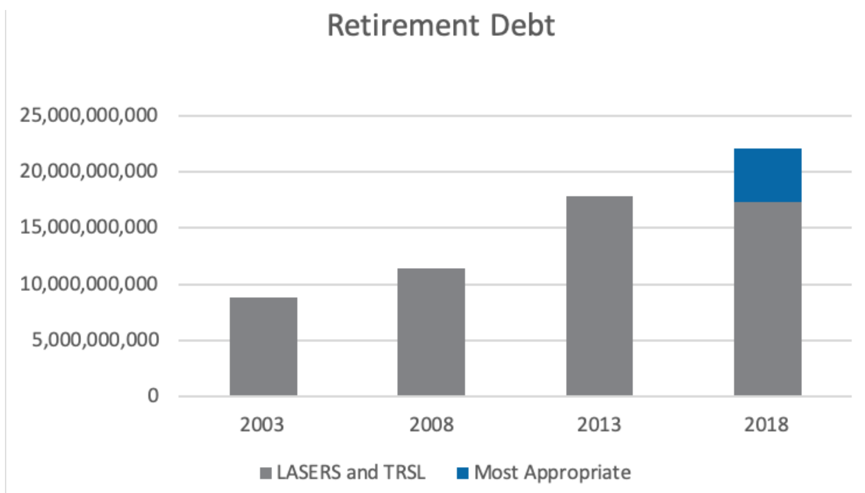
This system, while providing protection for employees, places the full financial risk on the employers, such as state agencies and school districts. If anything goes wrong with the investments or actuarial assumptions, the result is more pension debt and a corresponding higher annual contribution from the government.

For Louisiana's retirement system to work properly, the state has to anticipate accurately how much retirement money will be needed and then actually invest enough annually to keep up with those predictions and prevent a ballooning debt load. Over the past three decades politicians and retirement system officials wisely made and stuck to payment plans. Unfortunately, the state has adopted a rosier than real outlook on investments and as a result, the payment plans have been inadequate. Changing this habit is difficult because that requires Louisiana to face up to the real ongoing costs and spend a little more now rather than a lot more later.

How We Got Here

Until 1989, the pension systems were not financed according to actuarial projections. A large debt accumulated. In 1987, the state passed a constitutional amendment requiring that retirement debt up to mid-1988 be paid off by 2029. This led to an amortized schedule of payments for that debt, known as the Initial Unfunded Accrued Liability (IUAL). Decisions made about this payment schedule had huge consequences for the next generation of taxpayers. Payments started out low and were to increase over time. The state arranged for payments in the early years that were less than the interest charged on the outstanding balance, so the debt was allowed to grow even larger. All the state's payments on the schedule so far have been made, but the heavier costs were shifted to the future. In fact, until recently Louisiana only made interest payments and has started paying down the principal on the UAL just in the last few years.

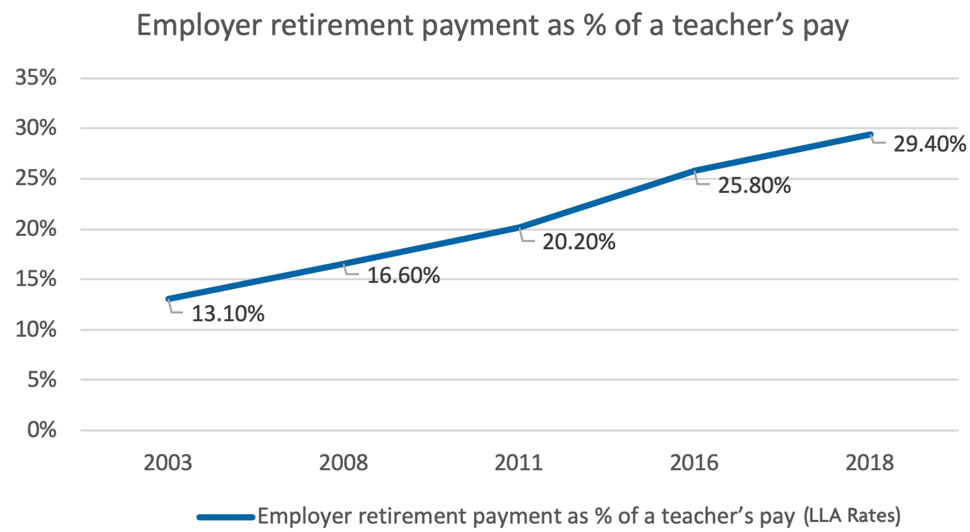
These past decisions explain in large part why these retirement systems often compare so poorly to other states. However, this historic debt is less than half the problem. Since the state began dealing with the old debt, a new unfunded liability has grown into an even larger beast. The biggest factor in the creation of the new UAL is investment performance. The retirement systems do not need to lose money in their investments to create debt, they just need to earn less on their investments than they assumed. The problem here is not that state retirement systems have done a poor job of investing, but that expectations have been too optimistic.



Source: Louisiana Legislative Auditor

In Louisiana, eternal optimists prevail to the long-term detriment of taxpayers and employees. For many years, the state's expected rate of return over time was above eight percent. The current expected rate of return is approximately 7.65% and is scheduled to ramp down to 7.5%. Among the large pubic retirement systems in the 50 states, 94% use a more realistic, lower investment return assumption for their portfolios than in Louisiana[v]. Private sector pension analysts also would consider this number to be high[vi]. The Louisiana Legislative Auditor (LLA) recently reported that UAL estimates are off by $4 billion compared to estimates using more "appropriate" conservative assumptions, which would be seven percent. The LLA also reported retirement systems are leaving certain long-term costs out of the equation, further masking the problem.

These investment losses are complicated by the odd way the state handles cost-of-living-adjustments (COLAs), which are given to retirees to help cover inflation. COLAs are a necessary part of a sound retirement plan. The Louisiana method of funding COLAs is through a mechanism created in 1992 known as the Experience Account. When retirement systems have particularly good returns on their investments, some of those investment earnings (or the "experience") is credited to a separate account. When funds build up to a certain level in the Experience Account, a COLA may be given. Thus, it is often claimed that COLAs are funded through the positive investment returns of the retirement system portfolios. In the retirement system lexicon, these are called "excess earnings," although there is really no such thing.



Source: Louisiana Legislative Auditor

Because market gains are siphoned off in good years to pay for future cost-of-living adjustments, losses from bad years are not as well offset. When the investment gains cannot stay far enough ahead of the losses over time, more debt accumulates. In short, the Experience Account does not add additional funding to the retirement systems to help pay for COLAs. Moreover, the state does not sufficiently adjust its expected rate of return to recognize this problem, according to the LLA. The result is a COLA system that is unreliable for the state, taxpayers and retirees.

Assigning the Costs

State retirement costs are covered by assessing a charge to agency employers for each employee or teacher. The actual current charge per teacher is about 26% of salary, with almost nine-tenths of that amount paying for debt. For state workers, the charge is 41%. Unfortunately, even these big charges are inadequate and are contributing to the pattern of never-ending retirement debt. The charge for teachers should be at least 29.4% with more appropriate assumptions, and optimally at 32.3%, according to the LLA's actuary. State workers should be at 48%.

Louisiana teachers cost more to employ on a per-pupil basis than the Southern regional average. And yet Louisiana teachers on average are paid below the Southern regional average salary[vii]. The relative cost to employ them is significantly increased because of the pension debt burden. This factor stifles pay raises and new hiring. State colleges face similar pressures, although they have been able to raise student tuition.

As a result of our retirement plan structure, Louisiana workers and teachers have no portability with their pension investment. The less time that workers spend in public service, the bigger the problem. Only five percent of members in the state government employee program (LASERS) will receive full unreduced benefits under the current plan, and about 70% of new employees will get no benefits, only a refund of their contributions, because they will leave government service before qualifying for benefits[viii]. Similarly, more than 40% of new teachers will leave the profession with zero retirement benefits and many others will not be well covered by the current system. This is especially significant in Louisiana, where state employees and teachers are among a very small percentage of American workers who are not enrolled in Social Security and therefore do not accumulate the benefits or portability of that federal program.

The state has made improvements to pensions, primarily in the form of benefit reductions. For example, limits have been placed on salary spikes and the use of overtime pay toward final average compensation calculations. New employees now must wait until 62 before collecting retirement benefits. The Legislature adopted a better and more cost-saving scheduling system for COLAs, then soon ignored it. Still, the state continues to carry the entire financial risk of the system.

Stopping the Eternal Debt

To break the cycle of interminable indebtedness and establish a better system for the long term in which the expense to employ state workers and teachers is dramatically reduced by lowering unfunded liabilities and correcting the practices that help create those liabilities, reforms should be implemented over the next four years with significant impacts felt in the 2030s and permanently beyond.

Changes to the state's broken COLA system would not eliminate the state's current unfunded accrued liability – because that is money owed – but they would reduce the risk of generating future additional retirement debt. Eventually, Louisiana could enter a new era of adequately funded retirement plans, all to the benefit of employees and taxpayers.

The state punishes employees or teachers who work only a few years in government service before changing jobs, leaving them with no employer-funded retirement benefits or Social Security benefits. In the private sector and in the public systems of many other states, retirement plan portability and an agile workforce are recognized facts of life. Louisiana's state and local governments should modernize to stay competitive in the job market and be fair to workers and teachers. Various options can be pursued to provide more portable and meaningful retirement benefits to shorter-term employees.

The solutions to pension problems flow from the causes. The state must learn the lessons of the past and make sufficient payments toward the UAL. For years, the state has steadily kept on pace with its scheduled payments toward the UAL, thereby avoiding even more costly long-term financing options. Good policy says Louisiana should not fall below this pace. Even better policy dictates that Louisiana should be using more realistic assumptions about its investment returns. Overly optimistic assumptions make it easier for the state budget in the short-term but harder in the long-term, setting up a cycle of permanent heavy indebtedness.

The state's "experience account" method for COLAs is a broken methodology rarely used elsewhere. It is widely criticized by pension analysts because it induces long-term, debt-driven payments toward COLAs. The current method should be eliminated because it shaves earnings on the state's retirement investments that would otherwise reduce the UAL. A predictable, reasonable system for COLAs would allow them to be funded in advance. If COLAs are going to be given anyway, a set schedule should be developed. This could be combined with a new retirement plan as the state employee system proposed last year.

The Louisiana State Employees Retirement System (LASERS) has a history of proposing reforms to address some of these problems. In 2018, LASERS proposed a more portable hybrid system for new employees combining a traditional defined benefit plan with a defined contribution plan, plus moving to a better COLA process and a higher retirement age.

The RESET

Louisiana should seize the opportunity to lower taxpayer risks in the long run by adopting more conservative assumptions for investment returns, raising the retirement age further for new employees and fixing the broken COLA system.

Ultimately, the state should create a new type of retirement plan for the next generation of state workers and teachers. A complete conversion to a 401(k)-style investment plan is not advisable so long as Social Security is not an option to public employees in Louisiana. A hybrid plan could be a good option for Louisiana, if well designed and sufficiently protective of employee and taxpayer interests.

- **Louisiana should modernize retirement systems for shorter-term employees and teachers to keep a competitive job market.**
- **Louisiana should use realistic assumptions about investment returns and payment toward the unfunded accrued liabilities in the retirement systems.**
- **Louisiana should eliminate the broken "experience account" method for cost-of-living adjustments.**
- **Louisiana should consider the Louisiana State Employees Retirement System's (LASERS) proposal for a more portable hybrid system for new employees combining a traditional defined benefit plan with a defined contribution plan, plus moving to a better cost-of-living adjustment process and a higher retirement age.**

Endnotes

i Retirement systems' annual reports
ii Louisiana Legislative auditor actuarial reports
iii Public Sector Retirement Systems Project, Pew Charitable Trusts
iv ibid
v Louisiana Legislative Auditor
vi Center for Retirement Research at Boston College
vii MFP Task Force and Southern Regional Education Board
viii LASERS Fact Sheet, 2018