PREVENTING BANKRUPTCY

in the

Kansas Public Employees Retirement System

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by Barry W. Poulson, Ph.D.

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Executive Summary

Recent evidence reveals that the Kansas Public Employees Retirement System (KPERS) is one of the most underfunded pension plans in the country (59 percent funding ratio at the end of 2011) and that there is a high probability the plan will not have sufficient funds to meet pension obligations over the next decade. This funding ratio will deteriorate further under the new accounting standards discussed below. The solution to this funding crisis is to bring pension benefits into line with the costs of pension plans for individual employees. A number of states have successfully enacted structural reforms in their state pension plans to accomplish this objective, including defined contribution and hybrid plans. Unfortunately the recent reforms enacted in KPERS creating a cash balance plan for new employees fails to accomplish that objective. This study provides a roadmap for pension reform in Kansas, the major conclusions of the study are:

1. Use the New GASB Accounting Standard

The new GASB standards to be implemented in 2013 and 2014 will require realistic actuarial assumptions and reporting. It is time for Kansas and other states too incorporate this more realistic data in transparent and timely reporting and to use this data in policy formulation.

2. Enact Structural Reforms

Using more realistic actuarial assumptions, via new GASB standards, most states, including Kansas, will find that they face a funding crisis in their state and local pension plans. Kansas legislators must follow the lead of state and local governments that have successfully replaced these defined benefit pension plans with defined contribution or hybrid plans.

3. Bring Public Sector Pension Benefits In Line with Private Pension Benefits

Public sector workers receive wages and benefits equal to or greater than comparable employees in the private sector. The pension and other post employment benefits received by public sector workers are significantly above that received by private sector workers. The outcome of recent pension reforms is to bring convergence of pension benefits in the public and private sector.

4. Legal Challenges to Public Sector Pension Reform

Structural reforms enacted to solve the funding crisis in state and local pension plans have been and will continue to be subject to legal challenges, and Kansas is well positioned to meet these legal challenges.[1]

5. Bankruptcy, Not Bailouts

In Kansas there will be tremendous pressure to bailout failed state and local pension systems to avoid bankruptcy. Bailouts of pension plans create all the wrong incentives. If state and local governments cannot manage their pension plans and other financial affairs bankruptcy forces them to address these issues.

6. Launch an Education Campaign

Successful pension reform in other states such as Utah and Rhode Island has required a bi-partisan effort in the legislature and support from all the stakeholders. Generating this support for pension reform in Kansas will require an education campaign. Kansas citizens must understand that the current defined benefit pension plan is not sustainable. Solving the funding crisis in KPERS will require burden sharing by all the stakeholders, including current employees, retirees and new employees.

Introduction

State and local governments report the funding status of their pension plans in financial statements following standards set by the Government Accounting Standards Board (GASB). Historically those standards allowed state and local governments to use an actuarial model and to discount liabilities based on the long term yield on the assets held in the pension fund. The Kansas Public Employees Retirement System (KPERS) uses an eight percent discount rate comparable to that used in most state and local pension plans. GASB also allowed state and local governments to use a smoothing technique to calculate the funding status of the plans. With this smoothing technique, losses incurred on assets in one year could be averaged over several years.[2]

Most economists argue that these historical standards do not provide an accurate measure of the funding status of state and local pension plans.[3] This criticism increased with the devastating losses incurred by these pension plans during the recent recession, and the slow recovery from these losses in recent years. As criticism mounted, GASB conducted a review of these standards. As a result of this review GASB has adopted new standards, numbers 67 and 68, to be implemented in 2013 and 2014 respectively.[4]

This study explores the impact of the new GASB standards on the funding status KPERS. The evidence underscores the fact that the pension plan is not on a sustainable path. Recent studies reveal that Kansas has one of the most under-funded pension plans in the nation.[5] There is a high probability that KPERS will not be able to meet its obligations over the next decade. This study explores the options to reform this pension plans and prevent bankruptcy.

The Funding Status of the Kansas Public Employees Retirement System Using Current GASB Standards

KPERS has multiple plans covering different classes of employees. The largest of these plans is for teachers. As the following table shows, the funded ratio for the system as a whole, 59.2%, reflects the low funded ratio for the school plan, 52.1%. The only plan with a funded ratio above the critical level of 80% is the judges' plan at 82.4% (see table 1).

A recent study by the Center for Retirement Research at Boston College compares the funded status of state pension plans over the past decade (see table 2). The funded ratio for the KPERS plan declined from 85 percent in 2001 to 59.0 percent in 2011. The funding ratio for the Kansas pension plan is well below the average for the nation as a whole, only seven states have a lower funded ratio than Kansas.

The value of assets in the KPERS plan fell sharply during the stock market crash in 2008. The actuarial value of assets based on current GASB standards allows for a smoothing of these losses over a five year period. Using this actuarial value of assets, in 2008 unfunded liabilities increased from $5.5 billion to $8.3 billion; and the funded ratio fell from 71% to 59%. Using the market value of assets the unfunded liabilities more than doubled from $4.8 billion to $10.3 billion; and the funded ratio fell from 75% to 49% (see table 3.).

The funding status of KPERS has not improved much since the 2008 stock market crash whether we look at

Table 1: Unfunded Liability and Funded Ratio in KPERS Plans as of December 31, 2012 *(dollars in millions)*

Plan	Actuarial Liability	Actuarial Value of Assets	Unfunded Actuarial Liability	Funded Ratio
State	$3,913	$2,790	$1,123	71.3%
School	$12,114	$6,317	$5,798	52.1%
Local	$3,978	$2,436	$1,542	61.2%
KP&F	$2,449	$1,710	$739	69.8%
Judges	$152	$126	$27	82.4%
Total	**$22,607**	**$13,379**	**$9,228**	**59.2%**

Source: Kansas Public Employees Retirement System, Comprehensive Annual Financial Report 2012 p. 80.

Table 2: Funded Ratio in KPERS and National Average for State and Local Plans *(percent)*

Year	KPERS System	National Ave. for State & Local Plans
2001	85.0%	101.9%
2002	78.0	94.4
2003	75.0	89.4
2004	70.0	87.3
2005	69.0	86.0
2006	69.0	85.8
2007	71.0	87.1
2008	59.0	83.8
2009	64.0	79.7
2010	62.0	76.1
2011	59.0	74.8

Source: Kansas Public Employees Retirement System Comprehensive Annual Financial Report 2011, p.45, and Kansas Public Employees Retirement System Comprehensive Annual Financial Report 2012, p. 46; National Average is from The Funding of State and Local Pensions: 2011-2015, Center for Retirement Research at Boston College, Number 24, May 2012, p.10

Table 3: Unfunded Liability and Funded Ratio in KPERS Plans Using the Actuarial and Market Value for Assets 2006-2011 *(dollars in billions)*						
	2006	2007	2008	2009	2010	2011
Using Actuarial Value of Assets						
funded ratio	69%	71%	59%	64%	62%	59%
unfunded liability	$5.4	$5.6	$8.3	$7.7	$8.3	$9.2
Using Market Value of Assets						
funded ratio	76%	75%	49%	56%	59%	55%
unfunded liability	$4.2	$4.8	$19.3	$9.4	$8.9	$10.1

Source: Kansas Public Employees Retirement System Comprehensive Annual Financial Report 2012, p.80

actuarial values or market values of assets in the system. In 2011 using actuarial values the unfunded liabilities were $9.2 billion and the funded ratio was 59%. Using market values the unfunded liabilities were $10.1 billion, and the funded ratio was 55%.

A Morningstar study provides estimates of the unfunded liabilities in state pension plans on a per capita basis.[6]

Table 4: Unfunded Liability Per Capita in KPERS Plans Using the Actuarial and Market Value for Assets 2007-2011 *(dollars)*					
	2007	2008	2009	2010	2011
Using Actuarial Value of Assets					
unfunded liability per capita	$1976	$2947	$2729	$2942	$3285
Using Market Value of Assets					
unfunded liability per capita	$1714	$3649	$3336	$3181	$10130

Source: Morningstar, "The State of State Pension Plans: A Deep Dive Into Shortfalls and Surpluses", November 26, 2012, p. 11; and Kansas Public Employees Retirement System, Valuation Report as of December 31, 2011 p.10.

Table 5: KPERS Schedule of Employer Contributions 2002-2012 *(dollars in millions)*		
Year	Annual Required Contribution	Percent Contributed
2002	$260.5	79.7%
2003	282.3	78.9
2004	338.9	69.4
2005	381.8	68.6
2006	471.4	63.4
2007	531.3	63.9
2008	607.7	65.1
2009	660.8	68.0
2010	682.1	72.1
2011	710.0	74.0
2012	843.4	67.2

Source: Kansas Public Employees Retirement System Comprehensive Annual Financial Report 2012, p.46.

This represents the amount each person in a state must pay to fully fund this unfunded liability. Every citizen in Kansas must pay $3285 based on the actuarial value of assets, or $3606 based on the market value of assets to fully fund unfunded liabilities in the system. There are only twelve states with greater per capita unfunded liabilities than Kansas (see table 4.).

KPERS reports the annual required contributions under current GASB standards in the Comprehensive Annual Financial Report. The actual contribution rate is slightly above two thirds the required contribution rate to meet current GASB standards (see table 5.)

The ARC date is the date when the statutory contribution rate is equal to the actual contribution rate. Assuming an 8 percent return on the market value of assets all of KPERS plans are projected to reach this ARC rate date within the 30 year amortization period set in GASB standards. The State plan is currently within this ARC date, while that for the school Group and Local Group are estimated to be FY 2021 and FY 2017 respectively.[7] However, as the following section discusses, under the new GASB standards none of these plans will meet the ARC date within the requisite 30 year amortization period.

The Funding Status of the Kansas Public Employees Retirement System Using New GASB Standards

The new GASB standards "require governments providing defined benefit pensions to recognize their long-term obligations for pension benefits as a liability for the first time, and to more comprehensively and comparably measure the annual costs of pension benefits."[8] There are three major revisions in these standards:

1. Discount Rate

Most economists argue that the discount rate used to estimate liabilities should reflect the risk associated with the liabilities in each plan. Since pension benefits are guaranteed under state law, the appropriate discount rate is a riskless rate. Finance professors Robert Novy-Marx and Joshua D. Rauh suggest using the U.S. Treasury yield rate, about 2 percent, as a measure of this riskless discount rate, which is appropriate for guaranteed pensions.[9]

The new GASB standard is a compromise between a riskless rate and the traditional discounting rate based upon the expected return to assets in the plan. Liabilities will be discounted using a blended rate that reflects the expected return for that portion of liabilities covered by assets in the plan, and the return on high grade municipal bonds for the portion of liabilities not covered by assets, i.e. unfunded liabilities.

2. Asset Smoothing

Plan assets will be valued at current market values rather than averaged over a number of years.

3. Allocation Method

Early age normal/level percentage of payroll will be the only allocation method used for reporting purposes.

The new GASB standards will provide a more accurate measure of the funding status of state and local pension plans and the cost of meeting those obligations. The cost of these plans is measured using another GASB standard, the annual required contribution rate (ARC). ARC is the contribution required to fully fund the pension plan over a 30 year amortization period. It is comprised of normal cost - the present values of liabilities accrued in a given year - plus the payment required to amortize the unfunded liability over a 30 year period. State and local pension plans are required to report the ratio of actual to required contributions in their Comprehensive Annual Financial Report (CAFR).

The new GASB standards will significantly increase the cost of state and local pension plans in Kansas as measured by the ARC:

- The requirement to use current market values rather than actuarial values and the new liability measure will increase unfunded liabilities.
- The requirement to use a blended rate of discount will increase both normal cost and the cost of paying off unfunded liabilities over a thirty year period.

The Center for Retirement Research at Boston College has recently measured the impact of the new GASB standards on the funding status of state and local pension plans.[10] In that study the discount rate is the blended rate; assets are not smoothed over time; and the entry age normal/level percentage of payroll is used as the allocating method. The funding status of KPERS in that study is as follows in Table 6.

Table 6: Funded Ratios for State and Local Plans Under New GASB Guidelines, 2010 *(percent)*

Pension Plan	Current Liabilities	Current Liabilities with Market Valued Assets	Blended Liabilities with Market Valued Assets	Blended Rate
KPERS	62.0%	51.9%	46.1%	7.3%
National Average	76.4%	67.1%	56.8%	6.6%

Source: How Would GASB Proposals Affect State and Local Pension Reporting, Center for Retirement Research at Boston College, Number 23, November 2011, updated June 2012, Appendix B, p.11.

That study reveals that KPERS is among the most under funded plans in the nation. The funding ratio using the Blended Liabilities with Market Value of Assets is 46.1 percent which is significantly below the average ratio for the nation as a whole. There are only ten other statewide pension plans in the nation with funding ratios lower than that for KPERS.

The new GASB rules will significantly increase the costs and the required contribution rates for state and local pension plans to meet these standards. At this point there is no estimate of this increased cost. However, in a recent study Novy-Marx and Rauh estimate the cost of state and local pension plans using a risk free rate of discount.[11] They calculate the annual economic cost of the retirement benefits earned by workers. This cost is the present value of new benefit promises, otherwise known as service cost. Real Treasury yields (based on TIPS, Treasury Inflation-Protected Securities) are used to discount the liability resulting from an additional year of work. They then calculate the contribution necessary to pay off the unfunded liability in 30 years, plus the present value of all new benefit accruals over that time period. They use the entry age normal (EAN) method which leads to service accruals that are constant over the employee's career, reflecting the standard adopted in the new GASB rules.

Table 7: Service Costs as a Percent of Payroll

Pension Plan	Stated Cost	Revised Cost Using Treasury Discount Rate	Actual Contribution Rate	Revised Cost Actual Contribution Rate
KPERS	12.0%	21.9%	11.5%	1.9%
National Average	13.9%	28.2%	17.7%	1.6%

Source: Robert Novy-Marx and Joshua Rauh, The Revenue Demands of Public Employee Pension Promises, p.45.

Table 7 shows their estimate of service cost for Kansas' state and local pension plans in 2009. The table compares the stated service cost with that using the Treasury rate. The stated cost is 12.0 percent of payroll; the cost using the Treasury rate is 21.9 percent of payroll, an 83.5 percent increase. In that year, Kansas contributed 11.5 percent of payroll to state and local pension plans. The true cost of these plans was almost double that contributed to the plans. The service cost of state and local pension plans in Kansas is significantly below that for the nation; however, the revised service cost of these plans is almost double the actual contribution rate.

The increased cost of Kansas's state and local pension plans with a Treasury rate of discount results in a significant increase in required contributions to fully fund the plans. Table 8 shows the actual contributions, required contributions and the increase in contributions required for full funding.

In that year Kansas contributed $900 million to state and local pension plans. The contribution required for full funding with the Treasury rate of discount is $2.2 billion. The increase in contributions required for full funding is equal to 19.2 percent of payroll and 11.7 percent of tax revenue. The increase in annual required contribution per household for full funding is $1197.

Table 8: Current Contributions and Required Contribution Increases for Full Funding in Kansas

Current Contributions *($billions)*	$0.9
Required Contributions *($billions)*	$2.2
Increase in Required Contributions *(% of payroll)*	19.2%
Increase in Required Contributions *(% of tax revenue)*	11.7%
Increase in Required Contributions per household *($ dollars)*	$1197

Source: Robert Novy-Marx and Joshua Rauh, The Revenue Demands of Public Employee Pension Promises, p.47.

Reforming Private Pension Plans

The same pressures creating a funding crisis in public sector pension plans have been encountered in the private sector. In 2010 only 20 percent of private pension plans were considered safe, i.e. with enough assets to cover 80 percent of pension benefits; and, 39 percent of these private pension plans were classified as 'critical', meaning that they have just 65 percent of the required funding; remember Kansas will have a funding ratio of 46.1 percent under the new GASB standards.[12]

When "Rust Belt" industries like Coloardo Fuel and Iron went bankrupt, employees in defined benefit plans were left with little or no pension benefits.

Defined benefit plans are in fact becoming a rarity in the private sector. New economy companies, such as Google and Cisco Systems, do not offer employees a defined benefit plan; most of these new companies offer only a defined contribution plan.[13]

Many older private companies that offered defined benefit plans have chosen to freeze those plans.[14] When a private company freezes the pension plan, some or all of the employees covered by the plan, stop receiving some or all of the benefits from the point of the freeze moving forward, while previously earned benefits are protected.

1. A Hard Freeze

A hard freeze bars employees from earning any further benefits from a defined benefit pension plan. Employers can't take away pension benefits employees have already earned; employees become vested in all the benefits they have earned under the plan, but lose the right to continue earning future benefits.

A variation of the hard freeze bars employees from getting pension credit for future years under the plan, but allows their benefits to be determined by pay at the time they leave the plan, rather than at the date of the freeze.

A growing number of private employers have imposed such a hard freeze in their defined benefit pension plans. A recent poll of both large and medium sized firms showed that 40 percent had frozen or closed their defined benefit plans.[15] Most of these private companies offer a defined contribution plan as an alternative to the defined benefit plan.

2. A Soft Freeze

A soft freeze is one which precludes some, but not all, employees from receiving benefits from the defined benefit pension plan. A soft freeze is usually imposed when an employer precludes new employees from participating in a defined benefit pension plan, but continues the plan for existing employees. According to the Government Accounting Office (GAO) nearly half of private sector defined benefit pension plans are currently closed to new employees.[16]

Reforming State and Local Pension Plans

Most state and local governments continue to offer defined benefit pension to public employees. The most recent data shows that 80 percent of public employees rely on a defined benefit pension plan.[17] The defined benefit plans offered to employees in the public sector provide greater benefits than those provided to employees in private defined benefit pension plans.[18]

The widening gap between assets and liabilities in defined benefit pension plans has led many state and local governments, including Kansas, to enact reforms in these plans.[19]

Most of these state and local pension reforms have modified the parameters of the traditional defined benefit pension plans. These reforms include: increasing the retirement age and early retirement penalties; lengthening vesting periods; increasing the number of years used to determine final salary average; raising employee and employer contributions; and reducing cost of living adjustments.[20]

However, a number of states have enacted more fundamental reforms changing the structure of the pension plan. These structural reforms include defined contribution plans, hybrid defined benefit and defined contribution plans, and cash balance plans.[21]

There are a number of reasons why states have chosen to enact structural reforms in their pension plans. The basic reason is that structural reforms are designed to more closely tie pension benefits to contributions for individual employees. A flaw in traditional defined benefit pension plans is that the benefits accrued by retirees are not commensurate with contributions made to the plan on their behalf.

In defined benefit plans the benefits accrued by employees are disproportionately concentrated in employees who remain in the system until their retirement age in their 50s and 60s. For younger employees, especially those who leave the system at an early age, the pension benefits they receive are less than the contributions made on their behalf.

Structural reforms of state pension plans can also avoid many of the flaws in defined benefit plans that underlie the current funding crisis. Employees in defined benefit plans often game the system by boosting their salaries in the final working years used as the basis for determining pension benefits. Employers, citing budgetary exigency, often under fund the defined benefit pension plan. Politicians often boost pension benefits in periods of prosperity, but then fail to fund those benefits in leaner economic times. This moral hazard was especially evident during the prosperous 1990s when politicians promised generous pension benefits to employees and then failed to fund those benefits in subsequent years dominated by recession.

Finally, structural reforms can improve labor market efficiency. Traditional defined benefit pension plans distort incentives for employees leading them to make decisions, such as timing of retirement, that reduce labor market efficiency.

Many structural reforms of state pension plans have been opposed by public employee unions and pension fund organizations. This opposition is not surprising from a public choice perspective, this is a classic case of the special interest effect. The benefits of generous defined benefit pension plans are concentrated in these interest groups, while the costs are spread over a large group of taxpayers and beneficiaries of government services. The special interests are often successful in blocking structural reform, even when such reform is essential for the long run solvency of the plans and long-tern interest of beneficiaries.

However, as the magnitude of the funding crisis in state and local pension plans grows there is also growing recognition even by special interests, of the need for structural reform. Recent structural reform of state pension plans in states, such as Rhode Island and Utah, have received bi-partisan support. Special interests in those states, recognizing the potential for insolvency and bankruptcy of their pension plans have supported structural reforms needed to preserve the solvency of the plans.

The argument most often used against structural reform of pension plans is that of transition costs. The argument is that under GASB standards when a defined benefit plan is closed the state must increase contributions in the short run. It is argued that states must then use the level dollar amortization method which results in payments that decrease as a percentage of payroll over time. Recent research reveals that under GASB rules states enacting structural reform in their pension plans can and do use the level percentage of projected payroll amortization method such that payments are a constant percentage of payroll and increase over time as payrolls increase due to inflation.[22] This means that states enacting structural reform can reduce the cost of the pension plan in the short run as well as the long run. For example the recent reform in Rhode Island significantly reduced the cost of the pension plan within the first years of enactment.[23]

Many state and local jurisdictions have constitutional and statutory provisions guaranteeing pension benefits for public employees. Public employee unions argue that these guarantees prohibit modifications in benefits for their members. While scholars debate this issue, recent court rulings have set new precedents for pension reform.

Judges in Minnesota and Colorado have thrown out lawsuits challenging recent cuts in retiree pension benefits in those states. The judges ruled in separate decisions that the Minnesota and Colorado legislatures had the right to reduce cost-of-living adjustments in retiree benefits, saying that the benefits were not contractually protected.[24]

New legal precedents for modifying pension benefits at the local level have been even more dramatic. If a municipal pension fund runs out of money the city can file for bankruptcy under the Chapter 9 municipal code. A growing number of municipal governments have restructured their pension plans by filing for bankruptcy, including: Vallejo, California, Prichard, Alabama, and Central Falls, Rhode Island.[25] Faced with an actuarial emergency and the threat of bankruptcy municipal public employee unions are increasingly willing to renegotiate their pension benefits.

Table 9. State Defined Contribution (DC) Plans, Hybrid Defined Contribution and defined Benefit (DC/DB) Plans, and Cash Balance (CB) Plans

State	Legislative Year	PlanType*
Alaska	2005	Mandatory DC
Colorado	2004	Optional DC
District of Colombia	1987	Mandatory DC
Florida	2000	Optional DC
Georgia	2008	Optional DC/DB
Indiana	1997	Mandatory DC/DB
Kansas	2012	Mandatory CB/DB
Louisiana	2012	Mandatory CB/DB
Michigan	1996	Mandatory DC
Montana	1999	Optional DC/DB
Nebraska	2002	Mandatory CB
North Dakota	1999	Optional DC/DB
Ohio	2000	Optional DC/DB
Oregon	2003	Mandatory DC/DB
Rhode Island	2011	Mandatory DC/DB
South Carolina	2000	Optional DC/DB
Vermont	1998	Optional DC/DB
Utah	2010	Mandatory DC/DB
Washington	1998-99	Optional DC/DB
West Virginia**	1991	Mandatory DC

*CB – Cash Balance
DC - Defined Contribution
DB - Defined Benefit
Hybrid – DC/DB

** The West Virginia defined contribution plan for teachers was introduced in 1991, but was switched back to a defined benefit plan in 2005. That plan remains one of the most unfunded pension plans in the country.

Source: Comprehensive Annual Financial Reports of each state system

Table 9 summarizes the structural reforms enacted in state pension plans.

Nine states have at some point enacted a structural reform replacing their defined benefit pension plan with some form of defined contribution plan for state workers and/or teachers. In some states the defined benefit plan is replaced by a defined contribution plan; while in other states the new plan is a hybrid combining a defined contribution plan with elements of a defined benefit plan.

An additional nine states offer employees a defined contribution plan as an optional plan. When the defined contribution plan is offered as an option, only a small percentage of public employees have enrolled in the defined contribution or hybrid plan.

Three states now mandate a cash balance plan for new employees.

The structural changes in state pension plans enacted in recent years replace a traditional defined benefit plan with one of these alternative plans, the following is a brief description of each plan type:

1. Defined Benefit Plans

Most states continue to rely on a traditional defined benefit pension plan. A defined benefit pension plan is a retirement plan administered by the state or by a pension system on behalf of the state which guarantees or promises lifetime retirement benefits to qualified employees. A traditional defined benefit plan uses a formula to link benefits to the member's wages or salary, length of employment, or other factors. While most states require employee contributions, the amount of benefit is not based on contributions. Any risks associated with the guaranteed lifetime retirement benefits are bourn by the taxpayer, via the state or pension system, not by the employee.

2. Defined Contribution Plans

In a defined contribution plan the employer does not offer any guaranteed investment return or retirement benefit. Contributions by the employee and employer are paid into an individual account for each member. Money contributed to the account can be from employee salary deferral and/or from employer contributions. The contributions are invested and the returns are credited to the individual's account. Investment risk and reward is assumed by each individual employee/retiree and not by the employer. Upon retirement the member's account is the basis for retirement benefits.

Nebraska was the first state to offer a defined contribution plan, from 1967 to 2002.[26] In that year the plan was closed to new employees and replaced with a cash balance plan. Five states and the District of Colombia now offer a defined contribution plan as the primary mandated retirement plan for a designated group of employees, Alaska, Michigan, Minnesota, Utah, and West Virginia. Another seven states offer a defined contribution plan as an option to qualified employees, Colorado, Florida, Indiana, Montana, North Dakota, Ohio, and South Carolina.[27]

The Alaska plan is the most comprehensive defined contribution plan mandated for public employees. In 2006 the legislature closed the defined benefit plan for public employees and teachers to new enrollment and replaced it with a defined contribution plan.[28]

This reform enabled the state of Alaska to make significant progress in improving the funding status of the pension plan. The funded ratio increased from 65.7 percent in 2005 to 78.8 percent in 2008. Like most states the Alaska pension plan was hit hard by the recent recession, the funded ratio has since fallen to 61.9 percent. But the plan is on track to pay off unfunded liabilities over the amortization period.[29]

In the years since enacting this reform the state of Alaska has significantly increased contributions to the retirement system, more than meeting the actuarial required contribution. It is important to note that actuarial required contributions to the pension plan have fallen. On the other hand the actuarial required contributions to the post employment health care plan have increased. Alaska has a serious funding problem in the health plan but not in the pension plan.[30]

Critics of the Alaska reform argued that the replacement of the defined benefit plan with a defined contribution plan would increase the cost of the pension plan in the short run. The issue here is the amortization method. For a brief time after the reform Alaska used the level dollar amortization method, but has since switched to the level percentage of projected payroll amortization method. There is nothing in GASB rules that prohibits a state from using the latter amortization method in funding the pension plan.[31]

3. Hybrid Plans

A hybrid plan combines features of defined benefit and defined contribution plans. Benefits depend upon a rate of return credited to contributions, where the rate of return is either specified in the plan rules independent of the actual return on any supporting accounts, or is calculated with reference to the actual return on any supporting assets and a minimum return guarantee specified in the plan rules. Often these hybrid plans maintain a defined contribution plan for employee contributions and a defined benefit plan for employer contributions. Thus risks are shared between both employees and employers.

Hybrid plans have been chosen by a number of states enacting structural reform in recent years. Ten states have now introduced hybrid pension plans including Florida, Georgia, Indiana, Michigan, Ohio, Oregon, Rhode Island, Virginia, Utah, and Washington state.

The Rhode Island hybrid plan has received a great deal of attention because the reform impacted the benefits received by current employees as well as retirees and future employees.[32] In 2011 the defined benefit plan was closed and a new hybrid plan created for existing employees as well as new members of the system, with the exception of judges and some public safety employees. The hybrid plan includes a reduced defined benefit plan and a defined contribution plan creating individual accounts for each member. All members are required to contribute to the defined contribution plan and may not opt out of it.

Reduced benefits offered in the defined benefit component of the plan apply to current employees as well as new hires. The defined benefit multiplier, i.e. the percent of final salary added to the pension for each year of service, was cut from 2 percent per year to 1 percent per year for employees who served 25 years or more. Accrued benefits for current members were reduced by suspending the post retirement cost of living adjustment.[33]

Even though past benefits in the Rhode Island pension plan are protected there is a significant decrease in future pension benefits that can be earned by current employees. Other states have reduced benefits for new employees and retirees but not for current employees. Benefit reductions for retirees, i.e. reduced cost of living adjustments, in Colorado and Minnesota have been challenged in the courts. The courts have upheld those changes in cost of living adjustments, but those decisions have been appealed.[34]

It is not hard to understand why Rhode Island enacted this structural change. It has one of the most under funded pension plans in the nation with a funding ratio of 48.4 percent in FY 2010.[35] Unfunded liabilities in the pension plan were projected to increase from $4.7 billion to $6.9 billion in FY 2013. This increase was in part due to the more realistic assumption regarding future investment returns. Based on the actuarial valuation of the plan in FY2010 required employer contributions were projected to increase dramatically from 22 percent of payroll to 35 percent of payroll in FY 2013.[36]

The most recent financial reports reveal that the reform enacted in Rhode Island has significantly improved the funding status of the pension plan. Unfunded liabilities are now projected to decrease from $7.3 billion to $4.3 billion in FY 2013. The annual required contributions to the plan are projected to fall 40 percent from $689 million to $415 million. Part of this decrease in cost can be attributed to accounting changes. The amortization period was lengthened from 19 years to 25 years. That accounting change will reduce the annual required contribution for the next 19 years, followed by six years of higher required contributions.[37]

Actuaries counseled Rhode Island not to enact a defined contribution plan arguing that such a reform would require use of the level dollar amortization method. That appears to have been bad advice because other states, like Michigan, have enacted a defined contribution plan utilizing the level percentage of payroll amortization method and avoided any short run increase in costs.[38]

There are many reasons why the structural reform enacted in the Rhode Island pension plan may be the path chosen to address the pension funding crisis in other states. The pension reform in Rhode Island was a bi-partisan effort; the prime mover being Democratic State Treasurer Gina M. Raimondo. She was able to mobilize support for the reform by educating special interests as well as legislators about the magnitude of the funding crisis facing the state. The City of Central Falls (Rhode Island) entered bankruptcy proceedings which left public employees with reduced pension benefits. Given the under funding in the state pension plan there was a high probability that that plan would also go bankrupt at some point over the next decade. That plan assumed an 8.25 percent rate of return on assets even though actuaries estimated there was less than a 30 percent chance that would happen over the next twenty years. Restoring solvency to the pension plan required more than propping up the defined benefit plan. The hybrid benefit plan required burden sharing by all stakeholders including retired employees and current employees as well as future employees. Five lawsuits have been brought against Governor Chaffee and other Rhode Island officials challenging the reduction in pension benefits.[39]

4. Cash Balance Plans

Cash Balance plans are also a hybrid of both defined benefit and defined contribution plans, but combine these such that the employer has a more accurate estimate of potential future obligations. Each member has an individual account and employees and employers contribute to the account. Usually the employer contribution is a defined amount annually, based on wages and guarantee of a fixed rate of growth in the contribution. But these are not actual contributions but rather notional balances in hypothetical accounts. Members accounts are commingled in a single account which is managed by the employer. The guaranteed return eliminates downside risk for the employee. In some cash balance plans if investment returns make it possible the member accounts can receive a return above the guaranteed return. In that case both the employee and employer share the upside risk.

In 2003 Nebraska replaced its defined contribution plan with a cash balance plan for new employees in the state pension system. Members of the defined contribution plan were given the option to transfer to the cash balance plan.[40] Since its inception Nebraska's defined contribution plan was under assault from special interests who finally succeeded in putting more of the burden for their retirement on taxpayers with the regression to a cash balance plan.

In 2012 two states, Kansas and Louisiana, introduced cash balance plans.[41] Kansas replaced its defined benefit plan with a cash balance plan for most state and local government employees including education employees. Louisiana created a cash balance plan for most state employees and post secondary members of the teachers retirement system. The plan is optional for other teachers and public employees.

Three other states, Maryland, Montana, and Louisiana have recently considered replacing their defined benefit plan with a cash balance plan.[42]

The Cash Balance Pension Plan in Kansas

Governor Brownback in his 2011 State of the State address identified reform of the Kansas Public Employees Retirement System (KPERS) as one of the three priorities in budget reform. Over the past two legislative sessions several bills were introduced addressing long term funding of KPERS.[43]

■ HB 2333 (2012 legislative session)

This reform effort culminated in HB 2333, the designated Kansas Public Employees Retirement System Omnibus Bill for 2012. That bill makes a number of changes in the pension plan, the changes most important for the funding status of the plan are as follows.

Employer Contribution Increases.

Raises the cap on employer rate increases from the current 0.60 percent per year to:

FY 2014	FY 2015	FY 2016	FY 2017 and after
0.9%	1.0%	1.1%	1.2%

Increases state contributions to fund the unfunded liability of the state/school group until their funded ratio reaches at least 80 percent. Provides that 80 percent of the proceeds from excess real estate property sales will be used to pay down KPERS unfunded liability.

Tier 1 Members (effective July 1, 2013)

Creates a 90 day election period for Tier 1 members to choose between thes following contribution rate/benefit option:

Member Contribution Rates	Benefit Provisions
5% effective January 1, 2014 and 6% effective January 1, 2015	Increase multiplier to 1.85% for future service only, effective January 1, 2014
Or	
4% contribution rate	Multiplier is reduced to 1.4% for future service only, effective January 1, 2014

Source: Kansas Public Employees Retirement System Valuation Report as of December 31, 2011 p.2.

Tier 2 Members (effective July 1, 2012)

Eliminates the cost of living adjustment (COLA) for Tier 2 members. Those who return after December 31, 2013 will receive a higher multiplier of 1.85% for all years of service.

Current Tier 2	Revised Tier 2
6% contribution	6% contribution
1.75% multiplier	1.85% multiplier for all service starting Jan. 1, 2014
Includes cost of living increase	Eliminate COLA if retiring after June 30, 2012 (no impact for members retiring before July 1, 2012)

Source: Kansas Public Employees Retirement System Valuation Report as of December 31, 2011 p.2.

Tier 3 Members (effective January 1, 2015)

Creates a cash balance retirement plan for new hires on or after January 1, 2015. A single employer contribution rate which includes the unfunded liability payment and applies to the covered payroll of all Tiers will be used. A monthly benefit will be determined for Tier 3 members based on the members account value which includes the employees' contribution, an employer credit, and interest credit.

The effective date of the creation of Tier 3 members is January 1, 2015. Therefore the impact of this reform on the cost of KPERS is not captured in the most recent actuarial studies. However, the other reforms, including changes for Tier 1 and Tier 2 and the increase in the statutory cap on the employer contribution rate are reflected in that actuarial report.

Employee contributions	6%
Employee credit	Based on Years of Service 1-4 years: 3% compensation 5-11 years: 4% of compensation 12-23 years: 5% of compensation 24 years+: 6% of compensation
Interest credits	Annual 5.25% guaranteed interest on employee and employer account balances. Possible additional interest credits of 0% to 4% may be granted by the KPERS Board based on KPERS actual investment returns and funding
Retirement benefit	Guaranteed lifetime benefit based on account balance at retirement. Partial lump sum option up to 30% at normal retirement age

Source: Kansas Public Employees Retirement System Valuation Report as of December 31, 2011 p.3.

■ HB 2301

HB 2301 introduced in 2013 modifies several provisions in the cash balance plan, as of this writing it remains in committee.[44] It reduces the guaranteed interest credit rate from 5.25 percent to 5.00 percent. It also reduces the interest rate used to convert account balances to monthly benefits when an employee retires, from six to five percent. The bill maintains the remaining language in the current law.

KPERS requested that actuaries estimate the impact of HB 2333 on the cost of the pension plan.[45] These projections show that the impact of this legislation on the state/school plan is to increase employer contributions until FY 2026, after which employer contributions decrease to the end of the forecast period in 2061. Over the period as a whole the reforms save state and school employers about $8 billion. The impact of the reforms on the local plan is the opposite. Employer contributions are decreased until FY 2036, after which they increase to the end of the period. Over the period as a whole the new legislation increases local employer contributions of roughly $72 million.

KPERS also requested actuaries to estimate the impact of HB 2301 on the cost of the pension plan. That legislation is projected to reduce employer contribution rates about $ 7 billion over the period.[46]

■ HB 2380

HB 2380 also introduced in 2013, and in committee as of this writing, provides for three ad hoc cost of living adjustments (COLA) of one percent each to members who have been retired for at least one year.[47]

KPERS actuaries estimate the increase in the employer contribution rate with this legislation is .63 percent for the state/school plan, and .25 percent for the local plan.

KPERS actuaries estimate the increase in unfunded liabilities with this legislation is in excess of $500 million.

A Critique of the Cash Balance Plan in Kansas

A crucial question in assessing the impact of the cash balance plan is if the assumption of an eight percent rate of return on assets is too optimistic. KPERS requested actuaries to estimate employer normal cost in the cash balance plan assuming the rate of return on investments is lowered from eight to seven and six percent respectively.[48] These projections also assume a reduction in the guaranteed interest crediting rate and annuity conversion interest rate by one percent and two percent. With a lower rate of return on assets the normal cost of the plan is increased by three percent to five percent. Actuaries also provided a sensitivity test that assumes the annuity conversion interest rates is lowered to five percent and four percent. At those lower conversion interest rates the normal cost is reduced compared to the baseline assumptions.

What these actuarial projections reveal is how sensitive the funding status of the pension plan is to alternative assumptions regarding the rate of return on assets and the conversion interest rate. The cash balance plan gives the legislature the discretion to change the guaranteed interest crediting rate and the annuitization interest rate in response to lower expected investment returns and changing economic conditions. Legislators may interpret this provision as giving them flexibility to adjust the guarantees in the cash balance plan if their optimistic assumption regarding the rate of return on assets doesn't pan out. But this provision negates the whole purpose of a cash balance plan in providing greater certainty to tax payers, employers, and employees enrolled in the plan

This flaw is revealed by comparing the cash balance plan in Louisiana with that introduced in Kansas.[49] The Louisiana plan places a heavier burden on employees in terms of employee contribution rates. In the Louisiana plan the employee contributes eight percent of salary, and the employer contributes four percent of salary plus interest on the account. The Kansas plan requires employee contributions of six percent of salary, the employer contributions to the plan vary from three to six percent depending upon length of employment.

The most important difference between these two cash balance plans is in the guaranteed benefit to employees. In the Louisiana plan employees are guaranteed interest payments that are linked to the actuarial return on investments of the state retirement system, but which will not fall below zero. Members in the Kansas plan are guaranteed an annual return of 5.25 (5.00 if HB2301 is enacted) percent on their accounts.

One can never predict with certainty the rate of return on investments in a pension plan. However, the Louisiana plan is designed to minimize investment risk for taxpayers. Employees are guaranteed interest payments linked to the actual return on investments in the plan. This allows employees to share in the upside risk, but caps that amount based on actual returns on investment. The employer assumes the downside risk when that return falls below zero. Given the volatility of returns on investment and the low average return over the past decade the Louisiana cash balance plan is a prudent approach to pension reform that will create more certainty for employers regarding their obligations in the pension plans. That plan is more likely to reduce unfunded liabilities and costs of the pension plan.

In contrast the Kansas cash balance plan by guaranteeing employees an annual return of 5.00 percent imposes a higher risk on employers. A 5.00 percent rate of return on investment is significantly below the assumed rate of return in the current defined benefit plan. But that guaranteed annual rate of return is significantly above the average rate of return on investments in the state pension plan in recent years. It is also likely to be above the interest rate based on the interest rate on municipal bonds that will be set under the new GASB standards.

It appears that the Kansas cash balance plan retains the fatal flaw in the current defined benefit plan. It guarantees a generous benefit to members of the cash balance plan that will be difficult to fund given the expected investment performance of the state pension plan.

A final difference between these two cash balance plans is the date mandated to implement the plans. The Louisiana plan is mandated for new employees on July 1, 2013. The Kansas plan is mandated for new members on January 1, 2015.

Thus the Louisiana cash balance plan is more likely to be able to fund the benefits promised to new employees in the plan. With employer contributions linked to actual investment returns the Louisiana plan is more likely to meet these obligations and also to earmark funds to pay off unfunded liabilities in the pension plan. Since the cash balance plan is mandated for new employees beginning next year Louisiana is likely to see improvement in the funding status of the pension plan in the short run as well as the long run.

In contrast it is not clear that Kansas will be able to fund the generous benefits offered to new employees in the cash balance plan. Kansas public employers will bear a heavier share of the burden in required contributions. It is less likely that employers will be able to earmark funds to pay off unfunded liabilities in the plan. Given the long delay in implementing the cash balance plan there is no impact of this reform on the funding status of the pension plan in the short run. Depending upon actual returns to investments in the plan it is conceivable that the cash balance plan could actually cause the funding status of the Kansas pension plan to deteriorate.

Pension Obligation Bonds in Kansas

KPERS officials, and some elected officials, have proposed using pension obligation bonds to solve the funding crisis in the system. KPERS requested actuaries to estimate the cost impact of a $1 billion pension obligation bond.[50] The assumption is that the proceeds from the bond are placed in the KPERS trust fund earning an eight percent return. With that assumption, of course, the actuaries project that the issuance of pension obligation bonds will reduce the cost of the pension plan.

The rationale for using pension obligation bonds to pay off unfunded liabilities in the pension plan assumes that the state can borrow funds at a low interest rate and then earn a higher rate of return on the proceeds deposited with the pension fund. The flaw in this rationale is the assumption that KPERS will earn a higher rate of return on bond proceeds deposited in the KPERS fund. KPERS assumes an eight percent return on assets accumulated in the fund. For a number of years economists and actuaries have questioned this assumed rate of return and the use of this assumed rate to discount liabilities in the plan. The Government Accounting Standards Board has issued new standards, 67 and 68, to be implemented over the next two years, requiring state and local governments to use a lower interest rate, the mortgage bond rate, to discount liabilities in their financial statements. If we assume that a lower rate of interest, such as the municipal bond rate, is the interest rate relevant in discounting unfunded liabilities in the pension plan then it is not clear that issuing pension obligation bonds will generate returns above the interest cost on those bonds. If the returns fall below the interest cost on the bonds then this introduces an additional risk and could in fact exacerbate the funding problem in KPERS.

A major flaw in the proposed issuance of pension obligation bonds is the lack of nexus between the investment of the bond proceeds and payments for unfunded liabilities in the plan. The experience in other states is that sometimes bond proceeds are earmarked for other state expenditures. The most egregious example of this problem is the state of Illinois which issued $10 billion in pension obligation bonds and then used the proceeds to meet current expenditures rather than to pay off unfunded liabilities in the pension plan. Even if the state of Kansas would not commit this form of fraud on the taxpayers the fungible nature of state funding makes it impossible to guarantee the nexus between bond proceeds and the payment for unfunded liabilities in the pension plan. If legislators see that additional funds are available to pay off unfunded liabilities in the pension plan they may choose to allocate less general fund money to meet these pension obligations. The state has not allocated the annual required contribution (ARC) to KPERS for several decades and is not projected to do so for the foreseeable future. Legislators continue to promise pension benefits without allocating the funds required to meet these obligations. We should expect this moral hazard to be even greater with the issuance of pension obligation bonds.

Conclusion

The implementation of the new GASB standards in 2013 and 2014 should serve as a wakeup call for Kansas legislators. The legislature will no longer be able to obfuscate the magnitude of the funding crisis in KPERS. Realistic actuarial information regarding the funding status of KPERS must be included in the comprehensive annual financial reports. That actuarial information will reveal the real magnitude of unfunded liabilities and the risk of insolvency in the plan.

With the actuarial information required by the new GASB standards we should expect the Kansas legislature to again debate structural reform of KPERS. That discussion should be informed by an understanding of successful reforms introduced in other states.

The most recent actuarial reports for KPERS conclude that the new cash balance plan has improved the long term funding status for KPERS.[51] The reports note that the state, school, and local groups are in actuarial balance meaning that the statutory contribution rate is projected to converge with the actuarial required contribution rate before the end of the amortization period in 2033, <u>"if all actuarial assumptions are met in future years."</u> The underlining here underscores the fact that these actuarial reports incorporate assumptions under current GASB standards, most importantly the assumption of an eight percent return used to discount liabilities, and will be rendered meaningless when the new GASB standards take effect 2013 and 2014.

Even with the recent changes in the cash balance plan the fundamental flaw in the KPERS plan remains. The plan places new employees into a cash balance plan that guarantees a generous defined benefit. Contributions into the cash balance plan for new employees are merged with other contributions in the KPERS trust. If the trust fails to generate the assumed eight percent rate of return on assets then the guaranteed benefits for new employees as well as benefits guaranteed to other employees are at risk.

KPERS officials have also proposed the issuance of pension obligation bonds to pay off the unfunded liabilities in the KPERS plan. Even if the proceeds of pension obligation bonds could be set aside in a lock box and earmarked to pay off unfunded liabilities in the pension plan the state must still address the accumulation of unfunded liabilities in the defined benefit plan. Without fundamental structural change, including shifting public employees to some form of defined contribution pension plan, these unfunded liabilities will continue to accumulate. Legislators should not be diverted from this difficult task by non-reforms such as the issuance of pension obligation bonds. Shifting the cost of pension obligations from one generation of employees and taxpayers to the next generation is not a solution to the funding crisis in KPERS. The defined benefit plan offered by KPERS is simply not sustainable.

The actuaries chose not to analyze the funding status of KPERS under the assumption of different structural changes, such as a defined contribution or hybrid plan. This is surprising because many states now require actuaries to project the funding status of their pension systems for alternative structural changes using alternative assumptions regarding the rate of interest used to discount liabilities. When confronted with the magnitude of unfunded liabilities using realistic assumptions states such as Rhode Island, concluded that the risks of insolvency in traditional defined benefit plans is unacceptable and have replaced that plan with some form of defined contribution plan.

Kansas legislators should have required actuaries to project the funding status of KPERS with a defined contribution and hybrid plans and assuming a lower, more realistic rate of interest to discount liabilities. The assumption of a realistic rate of interest to discount liabilities significantly increases liabilities in the plan and also the annual cost of meeting these obligations. Such analysis reveals that using these more realistic assumptions the KPERS system is not in actuarial balance, indeed it is one of the most under funded pension systems in the country.

We have learned a great deal from the structural reforms enacted in state and local pension plans in recent years, including the cash balance plan introduced in Kansas. We conclude this study with a roadmap for pension reform in Kansas.

1. Use the New GASB Accounting Standards

It is time for a realistic appraisal of state and local pension plans. For too long these plans have been obfuscated by unrealistic actuarial assumptions, non-transparent financial reporting, and lags in publication that render the data out of date and irrelevant for policy makers.

Fortunately the new GASB standards to be implemented in 2013 and 2014 will require realistic actuarial assumptions and reporting. It is time for Kansas and other states too incorporate this more realistic data in transparent and timely reporting and to use this data in policy formulation.

Kansas should go beyond the new GASB standards and require actuaries to project the future funding status of KPRS under alternative actuarial assumptions. Projecting the funding status of KPERS using alternative discount rates, e.g. four percent, will reveal the risks of insolvency in the plan. They should publish this information so that it is understandable, readily accessible, and should do so on a timely basis.

2. Enact Structural Reforms

Using more realistic actuarial assumptions most states, including Kansas, will find that they face a funding crisis in their state and local pension plans. A number of local pension systems have already gone bankrupt and there is a high probability that more of these pension systems will not be able to meet their obligations at some point over the next decade. Actuaries should project the funding status of KPERS comparing the current plan with alternative plans incorporating structural reforms, including defined contribution plans and hybrid plans.

State and local pension plans can no longer defer the fundamental structural reforms required to make them solvent. Propping up failed defined benefit pension plans with band-aid reforms is no longer an option. Legislators must follow the lead of state and local governments that have successfully replaced these defined benefit pension plans with defined contribution and hybrid plans. These reforms have enabled employers to reduce unfunded liabilities in the short run as well as the long run. The claim that such reforms must inevitably increase the cost of pension systems is bogus. When state and local governments use the level percentage of projected payroll amortization method the cost and contribution rate of these pension plans is reduced in the short run as well as the long run.

3. Bring Public Sector Pension Benefits In Line With Private Pension Benefits

Public sector unions claim that wages and benefits for public employees are below that of private sector employees and therefore generous pension benefits are required to attract workers into these jobs. Whatever the relevance of this argument historically it is certainly not true today. Public sector workers receive wages and salaries equal to or greater than comparable employees in the private sector.[52] The pension and other post employment benefits received by public sector worker are significantly above that received by private sector workers.[53]

The outcome of recent pension reforms is to bring convergence of pension benefits in the public and private sector. These reforms are designed to equate pension benefits with pension costs for individual employees. The gold standard is a defined contribution plan in which employees and employers contribute to individual accounts which are owned by the employee, with benefits determined by the value of the account at the time of retirement.

However, other structural reforms, including hybrid and cash balance plans can be designed to achieve that outcome as well. But the devil is in the details, as we have learned from the cash balance plan introduced in Kansas. Pension benefits, such as the guaranteed return on cash balance plans, should be competitive with that for cash balance plans in the private sector.

4. Legal Challenges to Public Sector Pension Reform

Structural reforms enacted to solve the funding crisis in state and local pension plans have been and will continue to be subject to legal challenges, and Kansas is well positioned to meet these legal challenges.[54] The legal and constitutional constraints on pension reform vary from state to state. The most recent court decisions in Colorado and Minnesota upheld the right of those states to change the cost of living increase in benefits received by retirees, but those decisions are being appealed.

Several public sector unions have challenged the recent reforms in Rhode Island and this case will be heard by the Rhode Island Supreme Court. They have challenged the reduction in pension benefit for current employees as well as the reduction in the cost of living adjustment for retirees. They argue that these reforms are an abrogation of contracts. The state argues that the pension system was created by statute and can be changed by amending the statute. Further, the state argues that even if the pension benefits are viewed as a contract the state has the right to modify the contract in the public interest.

5. Bankruptcy, Not Bailouts

If the courts rule that states cannot reform pension plans as Rhode Island has, the alternative is bankruptcy. In bankruptcy all contracts are on the table including pension benefits. Rhode Island has already enacted legislation to protect bondholders in these bankruptcy proceedings. That is the only way that Rhode Island could guarantee access to bond markets for state and local governments. The precedent has already been set in Rhode Island for bankruptcy proceedings in which employees are left with reduced or no pension benefits.

In Kansas there will be tremendous pressure to bailout failed state and local pension systems to avoid bankruptcy. Legislation has been introduced in California that would make the state liable for unfunded liabilities in local pension systems. But the last thing that taxpayers in California need is for the state to bail out failed municipal pension plans on top of the hundreds of billions in unfunded liabilities accumulated in the state pension plan. States with unsustainable liabilities in their state pension plans can ill afford the cost of bailing out municipal pension plans. This lesson has been learned in Rhode Island as their local governments enter bankruptcy proceedings. In Illinois both state and local governments, i.e. Detroit, are promoting federal bailouts of their failed pension plans. Congress facing its own unsustainable pension system has introduced legislation that would prohibit such bailouts. Bailouts of pension plans create all the wrong incentives. If state and local governments cannot manage their pension plans and other financial affairs bankruptcy forced them to address these issues.

6. Launch an Education Campaign

Successful pension reform in other states such as Utah and Rhode Island has required a bi partisan effort in the legislature and support from all the stakeholders. Generating this support for pension reform in Kansas will require an education campaign.

Kansas citizens must understand that the current pension plan is not sustainable. KPERS assumes that employer contribution rates can be increased to whatever level is required to pay off unfunded liabilities. However, under realistic actuarial assumptions this would require employer contribution rates equal to 22 percent of payroll, about double the current contribution rate. At those rates most if not all new revenues would have to be earmarked to pay off unfunded liabilities in the plan, leaving little if any revenue for public education, highways, health care, and other programs. Increasing taxes simply to pay off unfunded liabilities in the pension plan would certainly meet taxpayer resistance. Taxpayers are no longer willing to assume the risks of a failed public pension plan.

Solving the funding crisis in KPERS will require burden sharing by all the stakeholders, including current employees and retirees as well as new employees. Attempting to muddle along with failed pension plans exposes employers to greater risk of bankruptcy in which employees are left with reduced or no pension benefits. As employees unions and pension administrators acknowledge this risk they are more willing to share in the burden of pension reform. Pension reform has become a bi-partisan issue.

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End Notes

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