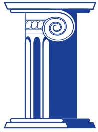

INSTITUTE BRIEF

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Iowa Needs to Focus on Pension Reform

By Deborah D. Thornton

Long-term Iowa-state-government fiscal health should concern all Iowans. While Governor Terry Branstad and the House of Representatives, led by fiscal responsibility, have brought state government back into a solid financial position, there are storm clouds on the horizon. And they're not bringing rain or snow but something more troubling.

These storm clouds are state-employee-retirement benefits, worth billions of dollars. These legislatively approved retirement benefits impact the state government budget, long-term fiscal liabilities, and taxpayers. Unfortunately, many people, including State Legislators, do not have a good understanding of pension-plan management. Nationally, 26 states have significant pension shortfalls and are at risk of default or bankruptcy.[1] This directly affects all of us, because the money must be found. Government pensions are another long-term entitlement with insufficient funding, similar to Social Security, Medicare, and Medicaid.

As outlined in the "State of State Pension Plans 2013" by Morningstar, an investment advisory firm, our northern neighbor, Wisconsin, has the strongest pension system in the country, at 99.9 percent funded, and an Unfunded Accrued Actuarial Liability (UAAL) of less than $20 per capita. This strong position is attributed to reforms passed by Wisconsin Governor Scott Walker (R). An important reform in Wisconsin was increasing the amounts employees paid into the pension funds.[2]

A pension plan is considered to be adequately funded if 80 percent of the money owed is available. Several of our neighbors are in this category, including Minnesota, Missouri, and Nebraska. In addition to Wisconsin, four other states are above 90 percent funded – New York, North Carolina, South Dakota, and Washington.

Anything less than 70 percent is significantly underfunded, as in Illinois. The reasons pension plans are in trouble include long-term historical underfunding, the extremely high level of benefits promised, and inclusion of education and local government pensions, which are outside of state control.

In most cases the defined benefit (DB) pensions promised to current employees cannot legally be changed or revised downwards. Courts ruled that promises made 5, 10, 15, or even 20 years ago must be upheld today. This does not apply to defined contribution (DC) plans, where as long as the promised money is paid in, the final pension money paid out is based on the returns of the investments.

Proposed changes include allowing voters to approve new pension plans and plan changes, as well as addressing pension-spiking and governance reforms.[3] Even well-funded plans became unstable following the 2008 stock market crash.

The Iowa Public Employees' Retirement System (IPERS) falls in the middle of the pack. The 2012 funded ratio is 79.5 percent, down from 88.6 percent in 2008, and just below the recommended "adequate" funding level. There is a shortfall of just over $6 billion, and the amount owed per capita, if it had to be made up today, is $2,041.[4] Iowa pensions are not in trouble — yet — but should have further reforms.

IPERS was originally set up in 1953 as a traditional DB system. The amount an employee receives in retirement is based on "years of service, a multi-year average covered wage, and a multiplier."[5] The money in a DB system comes from that originally put in and the growth from investments. This money must be equal to the money promised to be paid out.

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Changes in any of the three factors, money in, money growth, and money out, are critical to long-term success.

IPERS covers a wide range of government employees, including those working for public schools, state agencies, counties (99), cities, and townships. The majority (53.4 percent) are school employees, including the Regent universities. As of FY 2012, there were 164,200 active working employees, down almost 1,500 from 165,660 two years earlier (FY 2010),[6] and 101,948 retired employees, up almost 8,250 from 93,700. [7] The continuing decrease in the proportion of workers to retirees is a critical part of the risk of the IPERS system.

The increase in retirees supported and reduction in employees paying into the system creates a significant risk because a DB plan is basically a Ponzi scheme – if the previous money does not earn enough to pay the current beneficiaries, the new money is used to pay those beneficiaries. With fewer employees, there is less new money coming in to pay the retirees.

The Iowa Legislature made changes to IPERS in 2010 which took full effect in FY 2012. Major changes included increasing the employment time required for full vesting to seven years, using the "high-five" compared to a control year in determining retirement payments, reducing benefits more for early retirement, increasing the total contribution amount to 13.45 percent – the government paying 8.07 percent and the employee 5.38 percent – and allowing the contribution rate to float up or down by as much as 1 percent.[8]

The contributions to IPERS come from state taxes paid by private-sector workers. In Iowa, government employees make contributions to their own retirement from their paycheck, but all of the money originally comes from taxpayers.

Even if the amount of money in IPERS isn't sufficient to pay the promised benefits, that amount is still owed and will have to be made up. This is a key part of a DB retirement plan. No matter how much money is originally put in and how much (or little) it grows, the payout is still the same.

The question is, "Where will the rest of the money come from?" The answer is current taxpayers and future taxpayers: us, our children, and our grandchildren.

(Endnotes)

[1] "The State of State Pension Plans 2013: A Deep Dive into Shortfalls and Surpluses," Morningstar, September 16, 2013, p. 2, <http://corporate.morningstar.com/US/documents/Retirement/StateofPensions2013.pdf> accessed on October 3, 2013.

[2] Andrew G. Biggs and Jason Richwine, "Overpaid Public Workers: The Evidence Mounts," *The Wall Street Journal*, April 11, 2012, p. A13.

[3] Steven Greenhut, "Tackling the Pension Problem," *City Journal*, July 17, 2013, <http://www.city-journal.org/printable.php?id=9413> accessed on August 28, 2013.

[4] "The State of State Pension Plans 2013: A Deep Dive into Shortfalls and Surpluses," p. 15.

[5] "Iowa Public Employees' Retirement System," Center for State and Local Government Excellence, November 21, 2011.

[6] "FY2010 Comprehensive Annual Financial Report," Iowa Public Employees' Retirement System, December 15, 2010, p. ii, <http://www.ipers.org/publications/misc/pdf/financial/cafr/cafr2010.pdf> accessed on August 10, 2013.

[7] "FY2012 Comprehensive Annual Financial Report," Iowa Public Employees' Retirement System, December 14, 2012, p. ii, <http://www.ipers.org/publications/misc/pdf/financial/cafr/cafr.pdf> accessed on August 16, 2013.

[8] Ibid., p. x.

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