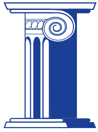

INSTITUTE BRIEF

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Innovative Pension Reform in Utah – an Example for Iowa

By Deborah D. Thornton

Many states are in significant financial trouble because of state-employee-pension liabilities. Some, including Louisiana, New Jersey, and Utah, are taking proactive steps to address this huge entitlement. [1]

The Iowa Public Employee Retirement System (IPERS) is fairly stable at a 79.5 percent funding level (down from 88.6 percent in 2008), but there are serious long-term viability issues which must be addressed. Specifically, the total IPERS liability as of FY 2012 for both retirees and current employees is $29.4 billion. The value of the paid in money plus investment profits is only $23.5 billion.[2] This is $5.9 billion less than is needed, or about a full year of the state's current budget – with no money to spend on anything else, from education to healthcare. To emphasize, making up the shortfall in IPERS would take a full year's state tax budget, without paying for anything else.

Another way to view this number is that after retirees are paid 100 percent of the money they've been promised and current employees have 100 percent of the money returned to them that they've paid in, the state would still owe current employees almost 50 percent of the money they have been promised.[3]

An important factor to be aware of is that in most cases the defined benefit (DB) pensions promised to current employees cannot, legally, be changed or revised downwards. Courts have ruled that the promises made by elected officials from 5, 10, 15, or even 20 years ago must be upheld today. Additionally, if a DB pension plan is actually closed, there are significant financial requirements on how the state must ensure the last employees to retire under this plan receive their promised money.

Pension reform has supporters on all sides of the political spectrum. In California, one "outspoken liberal Democrat" who is the San Francisco Public Defender was quoted as saying, "Today, we spend $1 out of every $7 on pension and benefit costs for city employees; by 2018, it will be one out of every $4."[4]

The worst possible situation for Iowa state government would be another major stock market crash while operating IPERS. These DB systems create two major risks in a market decline: first, the potential of not being able to pay the promised benefits, though legally required to, and second, those required payments resulting in both significant risk of potential bankruptcy for the state and large tax increases for all workers.

Innovative changes in Utah provide an example of successful reform. After the 2008-2009 recession Utah Legislators realized that even though they had done everything recommended, including funding the pension plan 100 percent every year, that one year of investment losses (minus 22 percent) resulted in a 30 percent long-term shortfall of millions of dollars. To make up the difference would require a 75 percent increase in state contributions for 25 years. This was even if investment returns remained strong (7.5 percent or higher) every single future year.[5] The shock came when Legislators realized this was 10 percent of their total state budget. It would have resulted in significant tax increases and a significant risk to the state economy.

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After reform, all new Utah state government employees will have a private-sector type 401k plan to invest in, controlling their own retirement by investing in low-cost mutual funds, and removing a long-term risk and debt from the state government. Utah now contributes 10 percent of every employee's salary to the 401k, a high percent in both private-sector and public-sector plans.[6] At the same time, the current employees have received a guarantee that their pensions are safe and will be paid.

They addressed closing risks by not actually closing their DB plan, but providing a hybrid option. Specifically, if the employee does not want to participate in the 401k but instead be in a more traditional DB plan, then the state still contributes 10 percent – but no more. If the required contribution is more than 10 percent, then the employee themselves must pay that difference from their current paycheck. If the required contribution is less than 10 percent, the remainder instead goes into the 401k. The state provides the same original money in either plan. Both current and future retirees are protected, as well as future taxpayers.

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 figuring average pay used to determine retirement payments, increasing the benefit reductions for early retirement, and increasing the total contribution amount to 13.45 percent, with the government paying 8.07 percent and the employee 5.38 percent.[7]

These changes will not, however, address the long-term result of poor investment returns, such as those earned in 2008, 2009, and 2012. A poor investment return, or even loss, in one year compounds the negative result for succeeding years – as Utah saw. As long as the pension plans are DB plans, with a promise to pay X amount no matter what, state government and future taxpayers retain significant risk. In contrast, once a Defined Contribution plan is funded, the future risk to the state and to taxpayers is removed.

If additional reforms are not implemented by the Iowa Legislature, IPERS will remain at significant financial risk of under-funding in the future. The amounts owed will have to be paid by future taxpayers — the younger workers of today and tomorrow. And many of these future taxpayers are already finding their future constrained because of a lack of jobs. Government pension plans must have significant additional reforms to remove this onerous burden.

(Endnotes)

[1] "The State of State Pension Plans 2013: A Deep Dive into Shortfalls and Surpluses," Morningstar, September 16, 2013, p. 15, <http://corporate.morningstar.com/US/documents/Retirement/StateofPensions2013.pdf> accessed on October 3, 2013.

[2] "FY2012 Comprehensive Annual Financial Report," Iowa Public Employees' Retirement System, December 14, 2012, p. 85 and 87, <http://www.ipers.org/publications/misc/pdf/financial/cafr/cafr.pdf> accessed on August 16, 2013.

[3] Ibid, p. 87.

[4] 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.

[5] Leonard Gilroy, "Closing the Gap: Designing and Implementing Pension Reform in Utah," Reason.org, September 17, 2013, <http://reason.org/news/show/utah-pension-reform> accessed on October 10, 2013.

[6] Ibid.

[7] "FY2012 Comprehensive Annual Financial Report," p. x.

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