Issue Analysis

A Case for Changing Public Retirement Benefits in Georgia (and Possibly Elsewhere)

By Allen Buckley[1]

Executive Summary

While state and local government financial problems are not as great as the federal government's financial problems, state and local government financial problems are substantial.

Georgia's non-teacher employees probably are paid as well or better, and their jobs are more secure, than their private-sector counterparts. Deferred compensation aside, Georgia's teachers are paid in line with teachers from other states and public school teachers are paid substantially more than private school teachers.

Georgia's pension plans are relatively rich and they have been well funded. However, Georgia's Other Postemployment Benefits plans (OPEB) have been poorly funded. New accounting rules for pensions and OPEB are likely to cause Georgia's combined pension/OPEB systems to be substantially underfunded beginning in 2014.

On a per-employee basis, the state's taxpayer-funded annual contributions to Georgia's pension plans are greater than what private sector employers typically contribute to retirement plans, including Social Security. State contributions have been growing substantially, and this trend will continue.

The pension plan for Georgia's teachers does not work well for most Georgia teachers.

Georgia can place itself on stable financial footing and tax Georgia's citizens fairly for work that is currently performed by Georgia employees by following other states' lead and converting Georgia's retirement systems to defined contribution-type systems. Substantial savings could be reaped for Georgia taxpayers in the future if such a change were made.

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Table of Contents

Overview

Numerous credible sources have recently reported that many state and local governments' post-retirement benefits are substantially underfunded. Particularly in light of the federal government's tremendous financial problems, these state and local retirement funding problems could cause substantial problems in the next five- to 15-plus years.

In some jurisdictions, the pension plan is sufficiently funded but post-retirement medical benefits are substantially underfunded.

Unlike the federal government, which can print money, most state and local governments must annually balance their budgets because constitutions and charters so provide. (The Georgia Constitution so provides in Article III.)

Going forward, substantial consideration should be given to changing the means of providing post-retirement benefits to public sector employees in Georgia in the manner set forth below.

Federal Financial Problems

U.S. Gross Domestic Product (GDP) was $15.7 trillion in 2012 and the current accumulated debt of the federal government is approximately $17 trillion.

- According to an August 8, 2012, Bloomberg article by Laurence Kotlikoff and Scott Burns, using the more realistic alternative Congressional Budget Office (CBO) scenario of federal finances, the value of the unfunded liabilities of the United States was approximately $222 trillion in 2012.
- Former U.S. Comptroller General David Walker recently tallied the unfunded liabilities at $73 trillion. For the third quarter of 2013, the net worth of all Americans combined was $77.3 trillion.

While the $222 trillion figure may be high, the present value of the unfunded liabilities at least roughly equals the net worth of all Americans combined, meaning that (over time) all or virtually all private wealth would need to be consumed to preserve the existing federal system.

In 2007, before the "Great Recession" and its accompanying tremendous amount of new federal debt, the U.S. Government Accountability Office (GAO) stated: "GAO's long-term simulations continue to show ever larger deficits resulting in a federal debt burden that ultimately spirals out of control."

The July 27-August 2, 2013, edition of The Economist magazine's cover page is titled, "The Unsteady States of America: Why the pensions nightmare is only just beginning."

Regarding American governments, the edition notes: "The truth is that America's whole public sector still operates in a financial never-never land. Uncle Sam offers an array of entitlements that there is no real plan to pay for."

So, barring very substantial change, our federal system is headed for a collapse. The remainder of this article assumes – perhaps unrealistically – that Congress and the Executive Branch of the federal government will somehow solve our nation's financial problems. If they are not solved, the resulting chaos would likely result in the states and local governments not honoring their obligations.[2]

[2] The current plan, which has existed for many years, apparently is to wait until the cliff is reached and lay on the brakes. One prominent Democratic economist has recommended letting the national debt grow until it reaches 130 percent of GDP, and then laying on the brakes.

State and Local Governments' Financial Problems

While not nearly as great as those of the federal government, the financial problems of state and local governments are substantial. According to an August 20, 2013, Bloomberg article by James Greiff that cites the Kennedy School at Harvard University, government pensions in the U.S. are underfunded by $4.4 trillion.[3] That breaks down to, on average, $88 billion per state. To put that in perspective, Georgia's tax revenue in 2013 was approximately $16.6 billion.[4]

The problems largely stem from past and current politicians making promises that will not need to be dealt with until long after they are gone from office. As George Will described the phenomenon in, "Detroit's Bankruptcy is a Bracing Dose of Reality:" "'IBG, YBG' – I'll be gone and you'll be gone when the reckoning arrives." (The Atlanta Journal-Constitution, August 4, 2013).

The problems largely stem from past and current politicians making promises that will not need to be dealt with until long after they are gone from office. As George Will described the phenomenon in, "Detroit's Bankruptcy is a Bracing Dose of Reality:" "'IBG, YBG' – I'll be gone and you'll be gone when the reckoning arrives."

Most state government constitutions require annual balanced budgets, but they also fail to prohibit actuarial funding of, or provide specific detail with respect to actuarial funding of, post-retirement benefits such as pensions. Therein is a large part of the problem.

The Economist edition cited previously also notes: "American cities and states must promise less or face disaster ... Many other [other than Detroit] state and local governments across America have made impossible-to-keep promises to do with pensions and health care." The genesis:

> Governors and mayors have long offered fat pensions to public servants, thus buying votes today and sending the bill to future taxpayers. They have also allowed some startling abuses. Some bureaucrats are promoted just before retirement or allowed to rack up lots of overtime, raising their final-salary pension for the rest of their lives. Or their unions win annual cost-of-living adjustments far above inflation. ...

Recently, a number of U.S. cities have filed bankruptcy. Cities can do so under Chapter 9 of the U.S. Bankruptcy Code. States don't have this option. In some city bankruptcies, retirees' pensions have gone partially or wholly unpaid. Many state constitutions prohibit cuts to public pension benefits. And, the U.S. Constitution, many state constitutions and state laws generally require that contracts (including contracts relating to employee benefits) be honored. Under the Supremacy Clause of the U.S. Constitution, federal law trumps inconsistent state law. At some point, the U.S. Supreme Court will need to resolve these issues.

Although it is now hard to see, the culmination of federal, state and local governments' failures to live within their means and adopt sustainable systems over many decades will create tremendous challenges in the near future.

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[3] In his September 10, 2013, article titled, "Pensions Are Still Making Ludicrous Assumptions about Future Returns," John Mauldin stated that if a 4 percent nominal rate of return was applied to discount future liabilities over the next 40 years, the total of the liabilities would be $30 trillion.

[4] On September 9, 2013, Moody's Investors Service reported that the states' median unfunded pension obligation amounted to approximately 100 percent of annual operations. Presumably, this more favorable result was based on more favorable interest rate assumptions.

What's Fair?

It is not possible to say *exactly* what is fair in terms of compensation of state and local government employees, of which employee benefits is a component. Obviously, different governments provide different cash and employee benefits packages. Different studies show very different results, in terms of who is paid more between state workers and private sector workers doing the same type of work. One thing is clear from the recent recession: There is much less job security in the private sector than there is in the public sector.

"Overall, the federal government paid 16 percent more in total compensation than it would have if average compensation had been comparable with that in the private sector, after accounting for certain observable characteristics of workers, " the CBO reported in "Comparing the Compensation of Federal and Private-Sector Employees" in January 2012.

Considering only wages, federal employees are, on average, paid 14.6 percent more than private sector employees in comparable jobs, according to a September 2011 Issue Brief of the Center for State & Local Government Excellence (CSLGE) titled, "Comparing Compensation: State-Local Versus Private Sector Workers."

The CBO article noted that, on average, the hourly cost of federal benefits was 48 percent higher than the cost of private sector benefits.

One Side of the Coin: Concerning state and local government employees other than teachers, an April 2010 article by Keith Bender and John S. Haywood for the CSLGE titled, "Out of Balance? Comparing Public and Private Sector Compensation over 20 Years," concluded that wages and benefits are 6.8 percent lower for state employees and 7.4 percent lower for local employees, than their private sector counterparts with "comparable earnings determinants." The conclusions were criticized for several reasons in a Reason Foundation article of May 10, 2010, by Adam Summers titled, "Comparing Private Sector and Government Worker Salaries."

The September 2011 CSLGE article mentioned earlier concluded that, based on wages and benefits, state and local government employees are paid 4 percent less than their private sector counterparts. This analysis did not break out state employees from local government employees. It valued job security as worth 6 percent of compensation, but did not include it in its 4 percent conclusion. (Thus, if included, state and local government employees were paid approximately 2 percent more than their private sector counterparts.)

The article concluded: "Given all assumptions required, the best way to describe the respective compensation levels is roughly equal." Apparently, the CSLGE retreated on its original position that state and local employees are paid less than their private sector counterparts.

The Other Side of the Coin: A September 27, 2012, issue brief by Citizens Against Government Waste (CAGW) titled, "Public Servants or Privileged Class: How State Government Employees are Paid Better than Their Private-Sector Counterparts," points out: "Nationally, no state government pays its employees on par or below what the private sector pays its employees, despite identical occupations in both sectors."

CAGW utilized an economic analysis performed by John Dunham and Associates (JDA) that analyzed 22 occupational categories and compared public sector to private sector compensation in each state.[5] The issue brief states: "Of these 22 occupations, state government paid on average 6.2 percent more in

[5] The 22 categories were: (1) management; (2) business and financial operation; (3) computer and mathematical; (4) architecture and engineering; (5) life, physical and social science; (6) community and social service; (7) legal; (8) education, training and library; (9) art, design, entertainment, sports and media; (10) healthcare practitioners and technical; (11) healthcare support; (12) protective service; (13) food preparation and serving related; (14) building and grounds maintenance; (15) personal care and service; (16) sales and related; (17) office and administrative support; (18) farming, fishing and forestry; (19) construction and extraction; (20) installation, maintenance and repair; (21) production; and (22) transportation and material moving.

wages and benefits than the private sector, averaging about $31 per hour in state government versus $29 in the private sector."[6]

Maury Gittleman and Brooks Pierce, research economists with the Bureau of Labor Statistics, noted in "Compensation for State and Local Government Workers," in the Journal of Economic Perspectives: [7]

> After controlling for skill differences and incorporating employee costs for benefits packages, we find that, on average, public sector workers in state government have compensation costs 3-10 percent greater than those for workers in the private sector, while in local government the gap is 10-19 percent.

Regarding average hourly pay, according to the authors, "Spending on health insurance in the government ($4.30 at the state level and $4.56 at the local level) is more than double that in the private sector ($2.14), while expenditures on retirement and savings are more than triple ($3.18 and $3.37 versus $1.00)."[8]

Concerning job security, the article provides:

> ... [J]ob security is better in the public sector, which has been an especially salient point in recent years. According to data from the Job Openings and Labor Turnover Survey (JOLTS), the annual layoff and discharge rate for the private sector ranged from 17.6 percent to 22.8 percent from 2006-2010 in contrast to a range of 5.9 percent to 7.0 percent for state and local governments.[9]

Who is Right? It is difficult to say what or who is correct, in terms of the comparison of state and local government employees' compensation to the compensation of private sector employees working similar jobs. Biases exist.

The author believes that the most credible source is the Gittleman/Pierce article. CSLGE changed its position from one of government employees being relatively underpaid to one of them being roughly equally paid. Furthermore, as one would expect, the CSLGE Web site notes significant connections to governments.[10] CAGW is basically opposite of CSLGE in the pertinent respect.

In contrast, Gittleman and Pierce are federal employees. Their analysis used a hybrid of the two most common means of analysis.[11] Based on the Gittleman/Pierce analysis, state government employees are paid 3-10 percent more than their private sector counterparts.

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[6] The author could not reconcile this percentage figure, given the percentage differences between the average private sector wage and the average state wage for each individual state that were supplied in the analysis.

[7] "Compensation for State and Local Government Workers," Maury Gittleman and Brooks Pierce, Journal of Economic Perspectives, Winter 2011, pg. 218. (According to the article, the authors are research economists with the Bureau of Labor Statistics, Washington, D.C.)

[8] Ibid, pg. 223.

[9] Ibid, pg. 238.

[10] The Mission of the CSLGE Web site is listed as follows: "The Center's mission is to promote excellence in local and state governments so they can attract and retain talented public servants. [new paragraph] With an aging workforce and powerful demographic forces, we cannot assume that state and local governments will be able to attract and retain the talent they need to operate in an increasingly complex world." (*Clearly, reducing pay would make state and local government jobs less appealin*g.) Furthermore, the "Support the Center" section provides: "With your support, the Center can offer grants to reimburse governments for the costs of professional development workshops and programs for their employees."

[11] Based on a Web site review, the Journal of Economic Perspectives does not appear to have a bias on this issue or any issue. The Gittleman/Pierce article analyzed the 2010 CSLGE article by Bender and Heywood.

It is clear that job security is much greater in the public sector, and any pay analysis should account for this important fact. Simply put, the financial fears that exist in the private sector are, generally speaking, substantial. Such is not the case for most public sector employees' jobs.

It is difficult to quantify job security. The 2011 CSLGE article placed a 6 percent factor on job security. Using a 6 percent security reduction and applying the lowest percent of Gittleman/Pierce's 3-10 percent differential (i.e. 3 percent), state government employees should be paid, on average, approximately 9 percent less than they are currently being paid to account for job security. Using the midpoint of the 3-10 range (i.e., 6.5 percent), state government employees should be paid approximately 12 percent less than they are currently being paid to account for job security. Using the high end of Gittleman/Pierce's differential, approximately a 15 percent reduction would be needed to make things fair.

How Does Georgia Stack Up? Of the above studies, the author could find specific state-by-state analysis only in the CAGW article. According to the CAGW article, Georgia state wages and benefits had a weighted hourly average of $38.47, while comparable job Georgia private sector wages and benefits had a weighted hourly average of $25.66, for a rounded hourly difference of $12.80.

In percentage terms, the difference was 50 percent. This difference was second only to Texas at $13.97 in terms of hard dollar average differential in favor of public sector employees. (The lowest differences were found in Utah and Montana, where the weighted average hourly rate differences were $3.96 and $4.09, respectively.)

In the Southeast around Georgia, the hourly weighted average differences for Alabama, Tennessee, South Carolina and Florida were, respectively, $8.52, $4.26, $5.51 and $6.57. The respective percentage differentials for Alabama, Tennessee, South Carolina and Florida were 36.7 percent, 18.2 percent, 23.8 percent and 27.2 percent.

Based on the CAGW report, Georgia is paying its non-teacher employees excessively and it is paying them more excessively than its neighboring states.[12]

It should be noted that there were *large* discrepancies in the 22 categories for Georgia. On one extreme, Georgia public sector business and financial operations personnel received average compensation of $60.70 per hour, while their private sector counterparts were paid $34.72 per hour (for a difference of $25.99 per hour). At the other extreme, Georgia public sector management personnel were paid $43.06 per hour while their private sector counterparts received $50.58 per hour (for a negative difference of $7.58 per hour).

For reasons noted above, the CAGW report's conclusions regarding Georgia compensation may be incorrect. It would seem that analysis should be undertaken to determine whether the CAGW paper's conclusions regarding Georgia compensation are accurate and, if not, determine the actual differences. Thereafter, analysis should be undertaken as to whether and where changes should be made. Job security, a subjective but important factor, should be part of the analysis. All things considered, it is likely that most of Georgia's public sector employees are paid more than their comparable private sector counterparts.

Teachers: Concerning teachers nationwide, a study by the National Center for Education Statistics showed that: "In 2007-2008, the average annual base salary of regular and full-time public school teachers ($49,600) was higher than the average annual base salary of regular full-time private school teachers ($36,300)." Public school class size (20.3 students per class) was slightly larger than private school class size (18.1 students per class).

[12] According to CAGW, CAGW has not received much negative (contradictory) feedback regarding the conclusions reached in its article. CAGW said that griping was heard from some unions. John Dunham of JDA said his firm had (also) not received contradictory feedback.

"Assessing the Compensation of Public School Teachers," a Heritage Foundation report by Jason Richwine and Andrew G. Biggs, concluded, among other things: (a) public school teachers earn higher wages than private school teachers, even when the comparison is limited to secular schools with standard curriculums; (b) pension programs for public school teachers are significantly more generous than the typical private sector retirement plans; (c) most teachers accrue generous retiree health benefits that are rarely offered in the private sector; and (d) job security for teachers is considerably greater than in comparable private sector professions.[13]

Concerning Georgia teachers, in December 2012, the National Education Association (NEA) issued its annual report providing the rankings of the States for 2012. Georgia's average teachers' salary was in the middle of the pack, landing at 22nd from the highest at $52,938. This salary figure did not include post-retirement benefits. Georgia's cost-of-living is roughly average among the states. So, post-retirement benefits aside, public school teacher pay in Georgia is (overall) reasonable relative to public school teacher pay in other states.

Types of Retirement Plans

Prior to discussing Georgia's retirement system and possible changes thereto, it is important to understand the various types of retirement plans.

Defined Contribution Plans

A defined contribution (DC) plan is just as it sounds. The amounts that go into the plan are defined by the plan document. Employer-funded contributions ordinarily are subject to a vesting schedule, and the employee eventually receives his vested account balance, including net investment earnings. Employee contributions, if they exist, are always fully vested. The required employer contributions must be funded annually, thereby fitting nicely with the balanced budget requirements of state and local governments. In other words, there are no actuarial calculations and there is no means to spike or create "IBG, YBG."

Because the plan must be fully funded annually, the taxpayers bear the current expense but no more. In retirement, the participants are entitled to receive whatever is in their accounts. Most private sector employees now receive their retirement benefits in the form of DC benefits. The 401(k) plan, which is primarily (and sometimes fully) funded by employee money, is now the predominant private sector retirement plan. Benefits are usually paid in a lump sum that can be rolled over to an individual retirement account (IRA) for further tax-free growth. Upon distribution from the DC plan or IRA, the benefits are subject to income tax.

Defined Benefit Plans

A defined benefit (DB) plan is just as it sounds. The benefits are defined by the plan document, usually by a formula based on years of service and compensation, and the employer and the employees (or just the employer) provide whatever funding is necessary to produce the future benefits. DB plans are often simply called "pension plans."[14] Typically, the ordinary benefit form is a life annuity (or, for married persons, a joint and 50 percent or greater survivor annuity). As such, benefits ordinarily are payable for life. And, life expectancies have been increasing.

In lieu of participants receiving an annuity, DB plans often permit participants to elect to receive a lump-sum benefit. In such a case, identical to a DC plan, the benefit can be rolled over to an IRA for further tax-free growth. Actuarial assumptions are made about things like future compensation, life expectancy and employee turnover to produce current contributions designed to fund future benefits.

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[13] "Assessing the Compensation of Public School Teachers," by Jason Richwine, Ph.D., and Andrew G. Biggs, Ph.D., Heritage Foundation, November 1, 2011.

[14] Technically, this name is a misnomer, because there are some DC pension plans.

Generally speaking, at any given point in time, a DB's plan funding ratio can be determined by dividing the plan's assets by the present value of the future cash benefits. In the private sector, outside union plans, it is relatively uncommon for a DB plan to include a cost-of-living adjustment (COLA) that increases benefits annually for inflation. However, such adjustments are common in governmental plans.

Several decades ago, DB plans were predominant in both the private and public sectors. The private sector has largely transitioned to DC plans, while most state and local governments, including Georgia's government, have continued to maintain DB plans. In the private sector, DB plans remain relatively common only with union employees.

It is important to note that investment risk is fully assumed by the employer with a DB plan. For a governmental plan, taxpayers bear the risk.

Spiking: One of the problems with DB plans, particularly those of state and local governments, is "spiking." Most traditional DB plans have a formula that bases benefits on a fraction of the "final average pay," the "high 3" or "high 5" years of pay. Final average pay means the average pay over the last few years of employment, such as three. The high 3 and high 5 mean, respectively, the highest three and five consecutive years of compensation.

Since compensation of any employee ordinarily increases over time, the last few years of employment prior to retirement ordinarily are used in calculating benefits. A formula might be 2 percent of final average pay, multiplied by years of service, up to a limit of 30 years of service. Spiking means doing things designed to maximize pay during the pertinent period for which the pension compensation variable (e.g., final average pay) is calculated. This practice is commonplace in many governments, and it is part of the buddy system that often exists in government. Pay might be increased by working overtime, doing more work than is ordinarily done or accumulating sick pay or vacation pay (that is included in the compensation base) and receiving the sick and/or vacation pay during the last year or two prior to retirement. There is no ability to spike with DC plans and cash balance plans (described below).

Funding: Unlike a DC plan, where the contribution requirement is fixed and must be made currently, a DB plan does not have a fixed annual contribution. Rather, practically, a DB plan must simply be funded as necessary to pay future benefits when they are due.[15] Because of the power of compounding, funding currently can substantially reduce the need to fund later.

From a practical standpoint, however, few politicians wish to place money in a fund that does not produce immediately recognizable tangible results favorable to voters. In contrast to a DC plan, a DB plan does not tailor nicely with states' balanced budget requirements: Benefits that accrue currently are not directly paid for currently, thus meaning future generations can be forced to pay for prior politicians' "IBG, YBG" actions.

Cash Balance Plans

A cash balance plan is a hybrid between and DB plan and a DC plan. Technically, it is a DB plan. Participants receive fixed promised benefits, and the employer funds the plan as necessary based on actuarial principles. Unlike a DC plan, where a participant has an actual account and the participant receives whatever the account grows to, a participant in a cash balance plan has a hypothetical account that grows with annual allocations that are a percentage of his compensation for any given year and interest credits specified in the plan. Many plans use a 5 percent interest credit. Most plans use the 30-year Treasury rate as their interest credit rate. (Several market interest rate options exist.) In the private sector, cash balance plans are popular with professionals and some large employers.

From the employee's perspective, all other things equal, a DB plan is superior to a DC plan because the employer bears the investment risk. For example, using specific actuarial factors that are designed to

[15] Private sector plans are subject to federal annual minimum funding standards. Governmental plan are exempt from these standards.

produce the exact same benefit at a given time (e.g., normal retirement age), the DC plan ultimately will produce a greater or lesser benefit than that anticipated based on the actuarial factors. In contrast, the DB plan will produce exactly the forecasted benefit.[16] For Georgia employees, the employer is the state and, indirectly, the taxpayers. Thus, the taxpayers bear the investment risk with respect to a government DB plan.

Accounting Rules

The very important accounting rules for public pensions and Other Postemployment Benefits (OPEB)[17] are in a state of flux. Currently and historically, governments have been able to pick the actuarial factors that apply in computing obligations. For many years, state and local governments have been permitted to utilize a market interest rate for both investment return assumptions and discounting of liabilities to present value. The most commonly used rate has been 8 percent. (A liability is valued in present value terms by discounting. For example, applying an 8 percent discount rate, a $108 liability payable one year in the future would have a present value of $100 (i.e., 108/1.08).)

Generally speaking, a pension plan's funding ratio is calculated by discounting future liabilities to present value, and then dividing the plan's assets by such discounted liabilities figure. Actuarial assumptions are used to estimate the future liabilities. The lower the discount rate, the greater are the liabilities; the higher the discount rate, the lower are the liabilities.

It is noteworthy to compare what private companies are doing, in terms of actuarial assumptions for pensions and OPEB. PWC's Pension/OPEB 2013 Assumption and Disclosure Survey provides results of a study based on plans of 100 Fortune 100 companies and other large and established companies. It provides that the average pension discount rates for the companies as of December 31, 2007, 2011 and 2012 were, respectively, 6.25 percent, 4.75 percent and 4.0 percent. For OPEB, the respective average discount rates on the same dates were 6.25 percent, 4.6 percent and 3.89 percent.

Regarding the significance of these changes, the survey finds: "For a typical plan with a benefit obligation of $1 billion, a decline in the discount rate of 75 basis points would add approximately $120 million to the balance sheet liability. Likewise, a decline in the discount rate of 225 basis points would add approximately $390 million to the balance sheet." The discount rate being applied to Georgia's DB plans is 7.5 percent.

The Governmental Accounting Standards Board (GASB) creates accounting and disclosure rules for state and local governments. In recent years, the GASB has been under pressure to require state and local governments to better account for and disclose their post-retirement benefit obligations. Current rules require disclosure of the annual required contribution (ARC) and the percent the ARC is funded. The ARC is composed of the normal cost (i.e., generally the present value of current year's benefit accrual) plus an allocable share of prior unfunded liabilities (not to be amortized over more than 30 years).

For plans years beginning after June 15, 2014, GASB rules will require very different accounting and disclosures by pension plans of state and local governments than those currently (and previously) required. As noted, historically, pension plan liabilities could be discounted to present value using the plan's expected investment return rate.

Next year, generally speaking, liabilities will be discounted on a nearest in time (in the future) basis using the plan's anticipated investment return rate until they equal the value of the plan's assets. Thereafter, liabilities will be discounted using the current average yield on high-grade (AA or higher) municipal bonds

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[16] In this regard, the Summary Annual Financial Report of the Teachers Retirement System of Georgia (TRS) for the fiscal year ended June 30, 2012, which was directed at participants, provides on page 6: "TRS is a defined benefit plan. ... Thus, defined contribution plans include more uncertainty and investment risk when compared to defined benefit plans."

[17] OPEB are post-retirement employee benefits other than pension benefits. Often, they are health care benefits.

(recently, approximately 3.7 percent). The unfunded liability will be "booked" as a liability. The ARC will no longer be part of the system. The potential impact of these changes on Georgia's retirement plans is discussed below.

The GASB has not yet determined what it will do with respect to OPEB. PWC made the following observation on page 7 of its December 3, 2012 HRS Insight article, "GASB issues new pension standards for state and local governments:"

> GASB resumed deliberations in July 2012. Because the board views all postemployment benefits similarly – all involve deferred compensation for services provided – the changes in the pension standards are likely to be a bellwether for the direction the board will take with respect to the OPEB standards. Issuance of an exposure draft is expected in 2014.

If the GASB follows the pensions approach to OPEB, then virtually all state and local governments will be required to book some very substantial liabilities. In this regard, while many state and local governments (including Georgia) have done a good job of funding pensions, almost all have set little or nothing aside for OPEB (mainly health care).

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The reasons for the failure to fund OPEB are sketchy. Zach Patton wrote in an article on February 3, 2011, in Governing, "Misplaced Pension Hysteria:"

> [T]he OPEB cancer continues to metastasize, unabated and untreated. … For perspective, the pension deficits accrued to date will cost every man, woman and child in America about $2,000 over the next 15 years (about $10 per month per capita), based on current funding ratios. For OPEB, ... the $2 Trillion national liability works out to six times that number .... Why doesn't OPEB get more attention? In part, the reason is that retiree medical benefits have never been funded, so there are no boards of trustees lobbying for their interests and sending out bills based on actuarial numbers. Public pension officials are smart enough to know they need to grab every penny of employer money they can get their hands on. OPEB remains unrepresented in the scramble for budget dollars. Public employees' pension rights under law are often stronger than their claims to retiree medical benefits. ... There are very few formalized statewide OPEB benefits for the media to inspect. ... Failure to quickly put OPEB plans onto sound, full actuarial footing as the economy gets back on its feet will assure a full-blown crisis before the end of this decade.

Another argument for not funding OPEB is that (unlike pensions) these costs are not fixed dollar outlays, because health care costs are the main driver and such costs cannot be estimated. This argument and similar arguments are meritless because, for reasons set forth below, these obligations very likely will be honored for the same or many of the same reasons that pension obligations will be honored.[18]

Given the potential grave liability figures that would be produced if GASB applied the pension approach to OPEB, look for the GASB to come up with something less drastic, as it did when it produced a hybrid discounting rate with respect to pension plans. Regardless of what the GASB decides, it is clear that from any realistic analytical standpoint, there is no legitimate reason for treating these liabilities different than pension plan obligations unless it can reasonably be assumed that a future legislature will (legally effectively) renege on these obligations. The ratings agencies such as Moody's will likely apply their own means of calculation.

[18] Georgia's Constitution and statutory law thoroughly cover pension plans. Title 47 of the Georgia Code has a very substantial set of rules applicable to governmental pensions in Georgia. However, very little authority exists regarding OPEB.

Georgia's Retirement Plans

There are two predominant public pension plans in Georgia. They are the Teachers' Retirement System (TRS) and the Employees' Retirement System (ERS). The TRS primarily covers teachers and education systems' employees. The ERS primarily covers other employees of the state and its political subdivisions. Both the TRS and the ERS are traditional DB plans. Of the two plans, the TRS is much larger in terms of promised benefits and assets.

Teachers' Retirement System. A participant's normal retirement benefit is equal to 2 percent of the two highest paid consecutive years of service, multiplied by the number of years of service up to 40 years. Thus, the maximum benefit is 80 percent of the two highest paid consecutive years of service. A participant is eligible for normal retirement benefits after 30 years of service, regardless of age. Alternatively, a participant with 10 or more years of service can retire after attaining age 60. Benefits are actuarially reduced for early retirement by the lesser of one-twelfth of 7 percent for each month the participant is below age 60, or 7 percent for each year or part thereof that years of service are less than 30.

Vesting occurs in employer contributions after performance of 10 years of service. Before that, an employee may receive a return of his or her contributions, plus interest.

According to the Notes to the Financial Statements of the State of Georgia for the fiscal year ended June 30, 2012, regarding TRS: "It is also assumed that certain cost-of-living adjustments, based on the Consumer Price Index, may be made in future years." The financial statements of the TRS provide the same, and assume future post-retirement COLAs of 3 percent annually. The TRS Web site provides:

> COLA adjustments are based on increases or decreases in the Consumer Price Index (CPI), and are compounded. If the CPI increases or remains the same, the adjustment will be 1½% each January and July. However, if the CPI decreases a COLA will not be awarded.

As noted, COLAs are uncommon in the private sector, and 3 percent ordinarily exceeds the inflation rate. For 2008, 2009, 2010, 2011 and 2012, the CPI was, respectively, 0.1 percent, 2.7 percent, 1.5 percent, 3.0 percent and 1.7 percent. Thus, given semi-annual compounding, benefits have increased over 16.1 percent in the past five years while compounded annual inflation has totaled approximately 9.3 percent. The CPI has not been negative since 1954. It would seem that the CPI should be the COLA.[19]

For the fiscal year ended June 30, 2013, employer and employee contributions of 11.41 percent and 6 percent (respectively) of annual compensation were made. Annually, employer and employee contributions have increased. The employer contribution rate for 2014 will 12.28 percent. According to the TRS website, the expected employer contribution rate for 2015 is 13.15 percent. The employer contribution increases and projected increases have been greater than employee contribution increases and projected increases. Employee contributions and scheduled contributions increased from 5 percent in 2009 to 6 percent in 2014 (a 20 percent increase) while employer contributions and scheduled contributions increased from 9.28 percent to 12.28 percent (a 32 percent increase) over the same time frame. *So, taxpayer-funded contribution percentages have been growing significantly.*

The TRS breakdown of employer contributions has been changing. For 2013, the 11.41 percent contribution rate was split 6.36 percent for normal cost and 5.05 percent for unfunded accrued liabilities. For 2015, the anticipated 13.15 percent contribution rate will be split 6.14 percent for normal cost and 7.01 percent for unfunded accrued liabilities. Unfunded accrued liabilities generally relate to benefit increases, investment gains and losses and differences between actuarial assumptions and actual results. The financial report for 2013 does not break down the unfunded liabilities, but it would seem odd for any benefit increases to exist. However, apparently, teachers transferring from other states, etc., can purchase years of service.

[19] Recently, the State of Illinois enacted important legislation to deal with its massive pension problems. Included in the fix was elimination of annual 3 percent COLAs for highly paid workers.

The number of TRS retirees and beneficiaries has gradually increased from 70,219 in 2006 to 97,317 in 2012. Over this time frame, annual benefit payments increased from approximately $2 billion to approximately $3.5 billion.

Employees' Retirement System. The ERS has three pieces to it. The first piece relates to employees hired before July 1, 1982 (the "Old Plan"). The second piece relates to employees hired after June 30, 1982, but prior to 2009 (the "New Plan"). The third piece relates to employees hired after 2008. The third piece is called the Georgia State Employees' Pension and Savings Plan (GSEPS). Members of the GSEPS can also participate in the GSEPS 401(k) defined contribution component.[20] Old Plan and New Plan participants can elect to switch to the GSEPS. Vesting occurs in employer-funded defined benefits following the performance of 10 years of service. Vesting occurs in the employer match to the GSEPS 401(k) plan in 20 percent increments over the participant's first five years of service.

The GSEPS 401(k) defined contribution component has an automatic enrollment rate of 1 percent. (Employees can reverse the enrollment). The 1 percent is fully matched by employer contributions. Thereafter, the next 4 percent deferred is matched at a rate of 50 cents on the dollar. Participants can direct investment of their accounts. Target date funds are the default investment.[21]

Under all three pieces of the ERS, a participant can retire after performing 30 years of service or performing 10 years of service and attaining age 60. Early retirement benefits are available to participants who perform 25 years of service and attain age 60. The benefit formula utilizes the highest 24 consecutive months of compensation and multiplies it by: (a) the number of years of creditable service; and (b) an applicable benefit factor. For Old Plan participants, the applicable benefit factor is 2 percent, except it is slightly greater than 2 percent if more than 28 years of service have been performed. For New Plan participants, the applicable benefit factor is 2 percent. For GSEPS participants, the applicable benefit factor is 1 percent. COLAs may be added to benefits of members hired prior to July 1, 2009. In practice, while COLAs have been added in the past, they have not been added in recent years.

The employer contribution rates for the ERS for the fiscal years 2011, 2012 and 2013 were as follows:

	2011	2012	2013
Old Plan	10.41%	11.63%	14.90%
New Plan	10.41%	11.63%	14.90%
GSEPS	6.54%	7.42%	11.54%

Most of the contributions for 2013 relate to past service costs. Participants are annually required to contribute 1.25 percent of their pay.

According to the letter from the actuaries that accompanied the financial report for the ERS for 2013, necessary employer contributions will increase to 17.21 percent for Old Plan participants, 21.96 percent for New Plan participants and 18.87 percent for GSEPS participants for the fiscal year ending June 30, 2015. So, similar to the TRS, *the ERS-required contributions of the state have been and are increasing substantially.*

[20] Technically, state and local governments are not eligible to sponsor 401(k) plans. Grandfathering exceptions may exist. State and local governments can adopt Internal Revenue Code §457(b) plans that can function similar to 401(k) plans.

[21] A target date fund is a fund whereby the investments become more conservative as the participant gets closer to retirement age. These funds tend to become heavily invested in bonds as a participant gets close to retirement. Generally speaking, investing heavily in bonds (particularly long-term bonds) is now risky, given the historically low interest rate environment, the anticipated increase in interest rates in the next few years, and the impact of an increase in interest rates on bond values. In this regard, the investments of the TRS and ERS have limited exposure to high-risk bonds. Many recent professional articles have attacked the general wisdom of target date funds.

Contributions to the ERS and a few smaller plans by the state increased from $300 million in 2012 to $408 million in 2013 (a 36 percent increase). During this time frame, participant contributions increased by 4 percent, from $120 million to $125 million.

Similar to the TRS, the composition of the required employer contributions has been changing significantly in recent years. For 2012, 4.67 percent of the 11.63 percent employer contribution rate was attributable to unfunded accrued liabilities. For 2013, 8.58 percent of the 14.9 percent employer contribution rate was attributable to unfunded accrued liabilities.

ERS retiree numbers have gradually increased from 28,562 in 2003 to 44,546 in 2013. Annual benefit payments have grown from less than $700 million in 2003 to almost $1.3 billion in 2013.

Both the TRS and the ERS have a supplemental retirement benefit plan (SERP) to provide benefits in excess of those permitted by the tax qualification rules of the Internal Revenue Code. Under Code §415, life annuity benefits for 2014 are generally limited to no more than $210,000 per year. For the fiscal year ended June 30, 2013, there were 41 TRS SERP participants and 108 ERS SERP participants.

OPEB. Concerning OPEB such as health care, in addition to a few small plans, Georgia maintains the School OPEB Fund, the State OPEB Fund and the Regents Plan. The School OPEB Fund provides post-retirement health care benefits to public school teachers and employees. The State OPEB fund provides post-retirement health care benefits to other state employees, other than university system employees (who are covered under the Regents Plan).

Under O.C.G.A. §45-18-2, The Board of Community Health of the State of Georgia (the "Board") is empowered to create health plans for State employees and retirees. The Board can also set premiums charged. Retirees can participate. If the retiree is eligible to participate in Medicare, the coverage is subordinated to Medicare coverage. (Medicare rules likely permit such subsidization.)

Perhaps because the OPEB benefits were deemed excessive, in December 2011 an amendment was made to Georgia's OPEB benefits system. The Board resolved to reduce benefits provided to retirees. As changed, employees with less than five years of service on January 1, 2012, are entitled to a pro-rated retirement subsidy based on years of service. Employees with 30 or more years of service will receive a 75 percent subsidy, provided the subsidy is no greater than the subsidy received by active employees. Also under the new policy, employees must have 10 years of service to receive any subsidy. The subsidy percentage increases each year that service exceeds 10 but does not exceed 30. Retirees and employees with five or more years of service as of January 1, 2012, generally are entitled to the subsidy offered to active employees (generally, 75 percent) upon retirement. Only employees participating in the Medicare Advantage Option are eligible to receive benefits.

It should be noted that the resolutions of the Board that called for the change described in the preceding paragraph evidence a concern about the lawfulness of the change and the ability of participants to enforce previously promised benefits. Specifically, one of the "WHEREAS" clauses provides: "WHEREAS, the Board desires to clarify that the announcement of the Annuitant Basic Subsidy Policy and the Annuitant Years of Service Subsidy Policy does not constitute a promise or contract of any kind." When such a "clarification" exists, it is often evidence of concern about promises previously made. Similarly, the last sentence of the last "ORDERED" clause provides: "Any subsidy policy adopted by the Board may be changed at any time by Board resolution, and does not constitute a contract or promise of any amount of subsidy."

Employer Contributions to Teachers' Pensions

Like most other public sector employees, most teachers (including Georgia's teachers) receive their retirement benefits from a DB plan. The benefits provided by the employer are virtually always greater than private sector employer-provided retirement benefits. According to a February 13, 2013, Heritage Foundation article by Jason Richwine titled, "Teacher Pensions Sweeter Than They Would Like You to Think:"

> Pensions for teachers and other government employees are much more generous, on average, than the retirement benefits received by comparable private-sector workers. This is beyond serious dispute among finance economists. In fact, the average teacher pension costs taxpayers several times as much as a typical 401(k) costs private employers. ... Fundamental reform is necessary.

A February 2009 article, "Teacher Retirement Benefits: Are Employer Contributions Higher Than for Private Sector Professionals?" makes several important findings.[22] Authors Robert M. Costrell and Michael Podgursky concluded that, including Social Security contributions, private sector employer retirement contributions from 2004 to 2008 remained in the 10.0-10.7 percent range, while contributions for public school teachers gradually grew from 11.9 percent of compensation to 14.6 percent of compensation. In 2007, for teachers not enrolled in Social Security, the average employer retirement contribution was 11.1 percent, while the average private sector employer contribution for both Social Security and a private employer plan totaled 10.3 percent. For teachers participating in Social Security in 2007, the employer contribution percent was 15.2 percent. The article concludes:

Moving Georgia's employees and teachers to reasonable DC plan or cash balance plan benefits on a prospective basis could be a means of placing retirement benefits more in line with private sector benefits.

> Our analysis of evidence from the BLS National Compensation Survey and the NASRA Public Fund Survey shows that the employer contribution rates for public school teachers are a larger percent of earnings than for private sector professionals and managers, whether or not we take account of teacher coverage under Social Security. In addition, the contribution rate for teachers is clearly trending upwards.

Relativity of Georgia's Pension Plans

Relatively speaking with respect to other states, the ERS is a rich plan. "A Comparison Study of State Employee Pension Programs," prepared by the Indiana Legislative Services Agency in 2006, showed Georgia's ERS as ranking seventh to ninth in terms of income replacement value. The ERS-required employee contributions were reported to be on the very low side. The "Tennessee Consolidated Retirement System (TCRS) Reform Options" analysis, dated February 22, 2013, (the "TN Analysis"), shows that ERS benefits are in line with other states but required contributions are relatively very low.

According to the TN Analysis, TRS provides middle-of-the-road income replacement benefits relative to other states' teachers' pension plans. However, the required employee contributions are on the relatively low side. One 2002 study ranked the TRS 16th among the state teachers' plans in terms of income replacement.[23] Thus, relatively speaking, the TRS is a rich plan.

Since non-retirement compensation for teachers is reasonable relative to the other states, it would be reasonable to reduce deferred compensation by a reasonable degree to cause overall compensation to be reasonable relative to other states. Also, as discussed further below, other states have been reducing, and likely will continue to reduce, benefits for their employees.

Moving Georgia's employees and teachers to reasonable DC plan or cash balance plan benefits on a prospective basis could be a means of placing retirement benefits more in line with private sector benefits.

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[22] "Teacher Retirement Benefits: Are Employer Contributions Higher Than for Private Sector Professionals?" Robert M. Costrell, University of Arkansas and Michael Podgursky, University of Missouri-Columbia, February 2009.

[23] "The Teacher Retirement Plan Income Replacement and Plan Comparisons," an OLR research report by Judith Lohman, dated April 17, 2002.

Funding of Georgia's Plans

Section X of the Georgia Constitution relates to retirement systems. Paragraphs I and II state that public funds may be expended for the purposes of paying and increasing benefits and other costs of retirement and pension systems of public officers and employees. Under Paragraph V: "It shall be the duty of the General Assembly to enact legislation to define funding standards which will assure the actuarial soundness of any retirement or pension system supported wholly or partially from public funds and to control legislative procedures so that no bill or resolution creating or amending any such retirement or pension system shall be passed by the General Assembly without concurrent provisions for funding in accordance with the defined funding standards."

By historical accounting standards and relative to the other states, the pension plans maintained by the state of Georgia have been relatively well-funded for many years.

By using the wording "retirement or pension system," given that "pension" clearly includes a pension plan, OPEB should fall within the definition of "retirement." Even if it does not, because OPEB obligations presumably will be honored, it would be financially irresponsible to fail to set aside funds for benefits accruing currently.

By historical accounting standards and relative to the other states, the pension plans maintained by the state of Georgia have been relatively well-funded for many years. In February of 2006, Georgia was named one of the five best states in the nation in terms of pension funding ratio. The ratio was reported at 101 percent. For 2013, the overall funding ratio was reported at a respectable 80.6 percent – slightly greater than the 80 percent standard that most agencies, etc., have deemed safe and prudent.[24] Required ARC contributions have been fully made for both the TRS and the ERS. However, recently adopted accounting changes that will be effective in 2014 (discussed earlier) will significantly weaken the funded status of all state and local government DB plans, including Georgia's DB plans.

Georgia's post-retirement medical benefits (OPEB) are *virtually completely unfunded*. The Notes to the Financial Statements of the State of Georgia for the fiscal year ended June 30, 2013, listed approximately $19.2 billion of liabilities along with assets of $1 billion.

Combining the pension underfunding of $16.5 billion with the OPEB underfunding of approximately $18.2 billion produces a deficiency of $34.7 billion. The combined funding ratio is 66.7 percent, based on combined assets of $69.6 billion and combined liabilities of $104.3 billion.

For comparison, the total tax revenue for the State of Georgia for the fiscal year ended June 30, 2013, was $16.6 billion.

The forgoing funding ratios use current accounting rules that permit use of a discount rate equal to the expected investment return rate. Future required accounting rules will produce a much lower funding ratio. Analyzing pension plans alone, according to a September 2013 article from State Budget Solutions, Georgia's pension plans are actually only 45 percent funded.[25] Author Cory Eucalitto did so using a "market value" approach to liabilities. He discounted liabilities using the yield on 15-year Treasury bond on August 21, 2013 (3.225 percent). Using this approach, the unfunded liability amount was over $85 billion.

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[24] According to the Notes to the Financial Statements of the State of Georgia for the fiscal year ended June 30, 2013, as of June 30, 2012, the actuarial value of the assets of the TRS and the ERS were (respectively) $56.3 Billion and $12.3 Billion. Meanwhile, their respective actuarial accrued liabilities were $68.3 Billion and $16.8 Billion, resulting in net underfunding of $16.5 Billion (i.e., (68.3 + 16.8) – (56.3 + 12.3)). These figures involved "smoothed assets," instead of actual assets.

[25] "Promises Made, Promises Broken – The Betrayal of Pensioners and Taxpayers," Cory Eucalitto, State Budget Solutions, September 3, 2013.

If Georgia's OPEB benefits qualify as a retirement system (and, it is difficult to see why they would not), then the Georgia Constitution is not being followed and the General Assembly has been neglecting its duty. While the pension obligations are larger than the OPEB benefits, the OPEB benefits are very significant. Particularly in light of the accounting changes noted above, Georgia has some significant financial problems.

Coming changes. The impact of the 2014 proposed changes outlined above on the 2012 average funding ratio for state and local governmental plans would be a reduction in the average funding ratio from 73 percent to 60 percent (i.e., a 17.8 percent reduction), according to the June 2013 "Issue Brief The Funding of State and Local Pensions: 2012-2016," produced by the Center for State and Local Government Excellence.

As previously noted, including OPEB, Georgia's funding ratio in 2013 was 66.7 percent. If the 17.8 percent reduction applied, then the combined Georgia pension/OPEB funding ratio would drop to 54.8 percent. However, the actual percent would be lower than 54.8 percent because the overall funding ratio (66.7 percent) is less than the 73 percent average for all plans.

Finally, it should be noted that the hybrid approach to liability discounting recently adopted by GASB favors state and local governments, in terms of rosiness of disclosure. Many or most economists consulted had recommended applying the high-grade municipal bond yield rate to all liabilities, as is being done by private sector plans. Doing so would drop the funding ratio of Georgia's combined pension/OPEB well below 50 percent. In any event, very soon, all of Georgia's major retirement plans (as well as those of most other states) will be substantially underfunded.

While analysis of local government funding situations is beyond the scope of this article, it should be noted that the city of Atlanta has some major funding problems. According to a Pew Charitable Trusts January 2013 article titled "A Widening Gap in Cities," using current accounting rules, the pension plans are approximately 60 percent funded and OPEB is completely unfunded. Combined, they are approximately 45 percent funded.

Under the new accounting rules scheduled to take effect in 2014, assuming the pension accounting rules will apply to OPEB, Atlanta's funding ratio will likely be in the 15-30 percent range. The credit rating agencies could soon downgrade Atlanta's bond rating and the bond ratings of many other major cities. (Chicago's rating was recently cut.[26])

Cobb County's 2012 status report listed its pension plan as being 53 percent funded as of December 31, 2012. Under the new accounting rules set to begin in 2014, Cobb's funding percent will drop well below 50 percent.

Legality of Changes to Benefits Outside Bankruptcy

In light of the financial problems that are coming more apparent each day, some legislators may consider attempting to reduce benefits. Whether an existing state or local government employee benefit plan can be eliminated or amended depends on the law specific to the state.

For private sector pension plans subject to ERISA[27], accrued benefits (i.e., earned annuity amounts payable at normal retirement age) cannot be reduced or eliminated. However, governmental plans are exempt from most of ERISA's substantive requirements, including the prohibition on reduction or elimination of accrued benefits.

State constitutions, statutes and case law determine whether a state or local government pension or OPEB obligation can be reduced. There are many ways by which a pension benefit can be reduced. For

[26] According to Reuters, on September 13, 2013, S&P changed the outlook on Chicago's A-plus general obligation rating to negative from stable.

[27] ERISA is the Employee Retirement Income Security Act of 1974. ERISA has been amended many times.

example, changing the definition of compensation to eliminate part of the components of the definition ordinarily will reduce benefits.

The U.S. Constitution prohibits state laws that impair contracts, and many state constitutions provide the same. However, under their police power, states ultimately can reduce benefits to a reasonable degree if necessary to protect the lives, health, etc., of the people.[28]

There are basically five analytical approaches to benefit reduction issues that are applied by the various states. In two states, under the "gratuity" means of analysis, state pensions can be reduced. Most states apply a contract analysis, whereby the employee ordinarily is entitled to the benefits promised. States vary on exactly what an employee is entitled to receive. Some states simply follow ERISA's anti-cutback rule, and protect benefits accrued to date. Others protect both accrued benefits and any benefit in existence since the employee's date of hire. In some states, the state constitution defines what is protected. A few states apply a property rights analysis to retirement benefits, under which benefits generally are not protected. Finally, one state, Minnesota, applies a promissory estoppel means of analysis, whereby reasonable detrimental reliance must exist by the employee in order to prevent changes. In her 2010 University of Minnesota Law *School* article, "Public Pension Plan Reform: The Legal Framework," Amy B. Monahan concluded:

> The legal regulation of public pension plans leaves much to be desired. The gratuity approach fails to adequately protect plan participants, the contract-based approach often fails to give states needed flexibility to adapt their plans to changing circumstances, promissory estoppel is too individualized to be administratively feasible, and the property rights approach appears to give participants too little protection. ...
>
> ... What needs to be protected ... are the benefits that have already been earned with respect to service already performed. Doing less is patently unfair to employees and retroactively changes the terms of the bargain struck between employer and employee. Doing more is unfair to employers (and, perhaps, to state taxpayers), locking them into an economic bargain that cannot be changed to respond to financial or labor markets, even when all other aspects of the employment relationship can be renegotiated.

Thus, Monahan recommends that the ERISA approach be followed.[29]

A May 2013 article by Monahan, "Understanding the Legal Limits on Public Pension Reform," noted there are two primary types of challenges to retirement plan changes: property rights challenges and contract law challenges.[30] She noted the ordinary lack of success of property rights challenges, and also noted the mixed results relating to contract law challenges. Her article stated regarding contract law challenges: "The United States Supreme Court has stated that legislation should not be held to create a contract unless it is entirely clear that the legislature intended to bind itself in the future. This is referred to the 'unmistakability doctrine.'" Finally, the article noted several legal challenges in various states, and the mixed results relating thereto. (COLA change challenges have been common.)

Georgia case law and the Georgia Constitution apply to state and local government pension plans in Georgia. Concerning pensions, the Georgia Constitution (Article X, Paragraph 3) only limits reductions to pensions of employees of county boards of education by providing that only the General Assembly has the power to modify benefits.

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[28] See Allied Structural Steel Co. v. Spannaus, 438 U.S. 241 (1978); U.S. Trust Co. v. New Jersey, 431 U.S. 1, 23 (1977); Higginbotham v. City of Baton Rouge, 183 So. 168 (La. 1938), aff'd by 306 U.S. 535 (1939).

[29] Generally speaking, the author agrees.

[30] "Understanding the Legal Limits on Public Pension Reform," Amy Monahan, May 29, 2013, American Enterprise Institute

Under case law in Georgia, an employee who works in exchange for promised compensation (in any form) is ordinarily entitled to the agreed upon compensation.[31] An August 2012 Issue Brief by the Center for State & Local Government Excellence titled, "Legal Constraints on Changes in State and Local Pensions," provides that, under contract law, Georgia protects not only accrued benefits (i.e., the ERISA standard) but also all benefits in existence since the employee's date of hire. The Issue Brief cites the National Conference on Public Employee Retirement Systems' 2007 ("NCPERS 2007") analysis and the plans' legal counsel for authority.

The author contacted Laura Quinby, one of the authors of "Legal Constraints on Changes in State and Local Pensions" regarding the authority provided by legal counsel. According to Quinby, the article originally stated (in draft form) that "past and maybe future" benefits were guaranteed. Quinby then inquired of both the TRS and the ERS regarding whether they agreed. According to Quinby, the ERS did not respond. However, the TRS, without citing authority, told Quinby that both past and future benefits were guaranteed. Although the requested authority was not supplied by TRS to Quinby, the article was changed to state what TRS had said (i.e., past and future benefits were guaranteed). Quinby also informed the author that the article did not question TRS' belief because it was believed to be consistent with NCPERS 2007. After learning the above information, the author contacted TRS and inquired about the authority. The authority provided by TRS via e-mail was:

> Constitution of the State of Georgia
>
> Article I, Bill of Rights Section I. Rights of Persons Paragraph X. Bill of attainder; ex post facto laws; and retroactive laws No bill of attainder, ex post facto law, retroactive law, or laws impairing the obligation of contract or making irrevocable grant of special privileges or immunities shall be passed.

NCPERS 2007 cited the above authority supplied by TRS as well as two cases, Swann v. Bd. of Trustees, 257 Ga. 450, 360 S.E.2d 395 (1987) and Withers v. Register, 246 Ga. 158, 269 S.E.2d 431 (1980). For reasons supplied below, the author believes that these authorities do *not* provide that both accrued benefits and any benefits in existence since the date of hire must be provided indefinitely.

Swann involved an individual who, through odd circumstances, participated in a newly created pension plan for approximately one year and then became entitled to a monthly pension that exceeded the amount of his monthly salary as a city councilman by 20 percent. Soon after the individual retired, newly elected members of the city council voted to completely eliminate his pension. In pertinent part, the Court ruled:

> Where a statute or ordinance establishes a retirement plan for government employees, and the employee contributes toward the benefits he is to receive and performs services *while the ordinance or statute is in effect*, the ordinance or statute becomes part of the contract of employment and is part of the compensation for the services rendered so that an attempt to amend the statute or ordinance to reduce, or eliminate, the retirement benefits the employee is to receive violates the impairment clause of the state constitution.

(Emphasis supplied.) Given that both the TRS and ERS are statutory creatures, the author believes that the foregoing quote means that the ERISA standard applies – i.e., accrued benefits cannot be reduced. It says nothing more. Nothing prohibits the legislature from prospectively amending the pension formula through a statutory amendment, as long as what has been earned through the amendment date is not reduced. In the private sector, DB plans are often "frozen," and whatever has been earned up to the freeze date cannot be taken away. For example, if an employee had accrued a $2,000 per month annuity

[31] *See* Hercules v. Adams, 150 Ga. App. 223 (1979); Fletcher v. Amax, 160 Ga. App. 692 (1981). ("It is the accepted law of this state that an additional compensation plan offered by an employer and impliedly accepted by an employee, by remaining in employment, constitutes a contract between them, whether the plan is public or private, and whether or not the employee contributes to the plan.")

at normal retirement age when the Legislature amended the applicable pension statute to change the benefit formula, he would always be entitled to this future $2,000 per month at normal retirement age benefit.[32]

Withers v. Register involved a scrivener's error, where participants attempted to collect a huge windfall. The *Withers* Court included language similar to the *Swann* language in its opinion:

> Long before the rule was recognized generally be the courts of the several states, it was the law of this state that a statute or ordinance establishing a retirement plan for government employees becomes a part of an employee's contract of employment if the employee contributes at any time any amount toward the benefits he is to receive, and if the employee performs services *while the law is in effect*; and that the impairment clause of our constitution (Art. I, Sec I, Part VII, Constitution of Georgia of 1976; Code Ann. § 2-107) precludes the application of an amendatory statute or ordinance in the calculation of the employee's retirement benefits if the effect of the amendment is to reduce rather than increase the benefits payable.

(Emphasis supplied.) Similar to *Swann*, the author believes that this language prohibits reduction to an accrued benefit (i.e., an amount that has been earned while the statute is in effect), but it does not prohibit amendment to the statutory authority to reduce benefits that accrue in the future. (The employees lost the case.)

An earlier Georgia Supreme Court case supports the ERISA rule. In Trotzier v. McElroy, 182 Ga. 719 (1936), the Georgia Supreme Court ruled that it was unlawful for the General Assembly to reduce a retiree's pension from $100 per month to $75 per month. In 1950, building on the *Trotzier* decision, the Georgia Supreme Court ruled in Bender v. Anglin, 207 Ga. 108 (1950), that the future fixed amount pension of an in-service employee could not be reduced from $100 to $75. The *Bender* court specifically noted:

> There is an exception to the general rule denying any vested right in gratuitous pensions, which is: where any particular payment under a pension plan has become due, the pensioner has a vested right to such due payment. ... It is well that at this point to emphasize that this exception applies to payments that have accrued and to them only, and it does not purport to confer vested rights to future payments that have not accrued. ...

So, pre-ERISA, the Georgia Supreme Court adopted the anti-cutback rule.

If the TRS and the ERS provided for fixed pensions (e.g., $2,000 a month at retirement), then those fixed amounts could not be taken away. Such is not the case. Rather, they provide for benefits that grow as years of service are performed. Thus, it should be lawful to change the benefit formula prospectively, provided what has already accrued is not reduced.

In January 2013, the Supreme Court of Florida handled the issue of what is protected in Scott v. Williams, 107 So.3d 379 (2013). The State of Florida amended a pension plan prospectively to eliminate COLAs and require employee contributions. The court essentially applied the anti-cutback rule, permitting the changes.

Many state and local pension plans include provisions that prohibit reductions to accrued benefits. The Cobb County pension plan has such a provision. Thus, essentially via contract, governmental plans ordinarily prohibit reductions to accrued benefits. However, the author could find no such provision in the

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[32] An example where a pension should be protected from the date of hire would be one where the employee had an employment contract that entitled him to unchanged pension benefits in all respects. However, to the knowledge of the author, such contracts are not entered into by the State of Georgia. In such a hypothetical case, only in an extreme case could the state's police powers be used to amend the agreement.

TRS plan document. According to ERS, there is no plan document for the ERS. It is this author's opinion that the ERISA standard applies to Georgia's public pension plans.

Concerning OPEB, ERISA essentially provides no protection for welfare benefit plans such as a health plan. However, some case law exists that protects welfare benefits such as health care under certain circumstances, such as detrimental reliance type situations. It is very likely that the contract provisions discussed above would apply to any attempted reduction to OPEB. While the applicable statutory authority permits Board changes to OPEB benefits, employees may be entitled to whatever was promised to them in writing (if anything) unless it can be clearly shown that the state always reserved the right to unilaterally reduce benefits and the employees were made aware of this right. A reservation of rights provision (to reduce or eliminate benefits) in a governing document generally is effective to permit an employer to eliminate welfare benefits such as OPEB. However, often, such provisions do not exist or did not exist at some point in the past. In this regard, what was told employees in writing could be controlling. However, ordinarily, oral statements regarding benefits are nonbinding.

One of the problems with a traditional DB plan is that, practically, a significant amount of benefits tend to accrue shortly before normal retirement age, and employees who do not work for one employer (or in one school system) for their entire career very often are shortchanged.

The law concerning exactly what determines benefit rights under ERISA is in a state of flux. Because trust law generally applies to non-ERISA plans and ERISA was largely drawn from the law of trusts, there is a good chance that ERISA principles would be applied by a court of law when deciding a governmental plan challenge (as has often been the case in the past).

In Cigna Corp. v. Amara, 131 S. Ct. 1866 (2011), the U.S. Supreme Court ruled, *inter alia*, that the plan document is what supplies benefits under ERISA. Other documents can potentially be used to support equitable remedies. Prior to *Amara*, many courts had ruled that the summary plan description (SPD) could override inconsistent plan terms.[33] Some courts necessitated detrimental reliance for an SPD to be controlling.

Since *Amara*, a few courts have analyzed the significance of the SPD. For example, in 2013, the U.S. Court of Appeals for the Sixth Circuit ruled in Tackett, et al. v. M&G Polymers USA, et al. that an SPD could be used as extrinsic evidence of plan intent. In this regard, the U.S. Supreme Court ruled in U.S. Airways, Inc. v. McCutchen, 2013 U.S. LEXIS 3156, that ordinary contract interpretation principles should be applied in determining plan intent. What was told to employees in writing concerning OPEB could determine the degree to which changes can be made to OPEB.

Absent a grave situation or unfair circumstances, it seems unlikely that anyone in Georgia government would attempt to reduce or eliminate promised pension benefits that have accrued or OPEB benefits that have been earned. However, it seems that OPEB benefits provided to "grandfathered" employees as of January 1, 2012, could be excessive in certain cases (e.g., when the retiree has not worked long before retiring), thus potentially providing equitable grounds for reduction in such cases.

Teachers' Pensions Problems

One of the problems with a traditional DB plan is that, practically, a significant amount of benefits tend to accrue shortly before normal retirement age, and employees who do not work for one employer (or in one

[33] An SPD is a plain English summary of the plan document's most significant provisions that is supposed to be supplied to participants.

school system) for their entire career very often are shortchanged.[34] A recent Center for State and Local Leadership at the Manhattan Institute study by Josh McGee and Marcus A. Winters titled “Better Pay, Fairer Pensions: Reforming Teacher Compensation,” notes that job mobility causes most teachers to be worse off under a traditional DB pension arrangement than they would be under a DC or cash balance arrangement that transferred some compensation from the DB plan to current pay on a cost-neutral basis.

The McGee/Winters article notes that “... only about 28 percent of American public school teachers remain in the profession for even 20 years. The overwhelming majority separate from service well before reaching the retirement thresholds in any public retirement system.” The Executive Summary of the article provides:

> [D]istricts should jettison their current approach to retirement benefits, in which teachers accrue relatively meager benefits through much of their careers, and then abruptly become eligible for much more as they near retirement age. In its place, districts should adopt retirement systems where benefits accrue smoothly, year after year, without sudden, arbitrary jumps late in a teacher’s working life. This would allow talented people to teach for part of their career, or teach in more than one district, without harming their retirement security. It would also end an unfair practice that places the majority of teachers on an insecure retirement savings path in order to support more generous pensions for the minority who work a full career in one system.

Both a DC plan and a cash balance plan would provide for more smoothly accruing benefits than the existing TRS.

States are making up their pension shortfall on the backs of their teachers, especially new teachers.

Consistent with the McGee/Winters article, a December 2012 paper by Kathryn M. Doherty, Sandi Jacobs and Trisha M. Madden for the National Council on Teacher Quality titled, “No One Benefits – How teacher pension systems are failing BOTH teachers and taxpayers,” notes the many shortfalls in traditional DB plans. From the perspective of teachers, it notes that the vesting schedule for most plans is too long, and that 15 states require 10 years in order to vest. (Georgia requires 10 years.) The number of states requiring such a long period to vest has increased in recent years. The article also notes that since 2008, 40 states have put the squeeze on teachers, by reducing benefits and requiring greater contributions. (Three-quarters of these squeezes were reported as having been done in 2011 and 2012.)

Among the recommendations the authors made were shorter vesting schedules and optional DC plans. The paper also noted how teachers who change employers and must start anew in a DB plan system will receive less, and sometimes a lot less, than those employees who stayed put in an identical DB plan system. It notes, “States are making up their pension shortfall on the backs of their teachers, especially new teachers.”

Other States’ Changes

Faced with mounting problems, a number of state and local governments have already moved from the traditional DB plan structure to DC and cash balance plans. *The Economist* article cited previously provides:

> States should accelerate the shift to defined-contribution pension schemes, where what you get out depends on what you put in. (These are the norm in the private sector.) Benefits already accrued should be honoured, but future accruals should be curtailed, where legally

[34] In this regard, salaries and wages generally increase over time, and the more years of service one has, the greater is his benefit. An employee who works for two different employers with identical pension plans will receive less than an identical employee who never switched jobs.

> possible. The earlier you grapple with the problem, the easier it will be to fix. Nebraska, which stopped offering final-salary pensions to new hires in 1967, is sitting pretty.[35]

Michigan transitioned to a DC plan in 1997. Since then, new employees have received a 4 percent employer contribution plus dollar-for-dollar match up to 3 percent of pay deferred by the employee. The change saved the state $2.4 billion over the first 13 years of the new DC plan's existence, according to a 2013 American Legislative Exchange Council (ALEC) article titled, "Keeping the Promise: State Solutions for Government Pension Reform," which cited a 2011 conclusion by Richard Dreyfus, an actuary and adjunct scholar with the Mackinac Center for Public Policy.

In Alaska, state and school employees hired after June 30, 2006, participate in a DC plan. The employer makes an 8 percent (of compensation) contribution, while state employees contribute 5 percent and school employees contribute 7 percent.

In 2012, Kansas adopted a cash balance plan. Employee participation in the plan will begin in 2015. Employees with more than 24 years of service will receive a 6 percent allocation rate and all other employees will receive a 3 percent allocation rate. The interest credit will be 5.25 percent. Up to an additional 4 percent of allocations will be made, depending on funding levels and investment returns.

Louisiana enacted a cash balance plan in 2012 for employees hired after June 2013 that provides for employee contributions of 8 percent of pay and employer contributions of 4 percent of pay. According to the TN Analysis, a Louisiana district court declared the new plan unconstitutional in January 2013 due to the way it was enacted. An appeal was pending.

According to the TN Analysis, South Carolina enacted legislation in 2012 that increases required employee contributions over the course of two years from 6.5 percent to 8.0 percent. The legislation also expanded the compensation period used to determine the pension amount from three to five years, and capped annual COLAs at $500.

Since 2009, according to the ALEC article mentioned previously, 19 states have limited COLAs in some way. The ALEC article also provides: "States are barred by federal law from filing bankruptcy, but in continuing to run structured deficits, they will become functionally bankrupt ..." The TN Analysis notes the numerous changes being made by the states to reduce pension benefits or require more of employees. States noted as increasing required employee contributions were Alabama, Florida, Maryland, Michigan, New Jersey, South Carolina and Virginia.

Based on the TN analysis, Tennessee is trying to change the way things have been done. Other states are facing up to reality. According to the Pew Charitable Trusts, in 2013 Kentucky faced up to its pension problems, committed to funding, reduced benefits and installed a cash balance plan to apply to employees hired after 2013.[36]

Possible Changes

Justification. There is justification for reasonable change to a DC platform. Generally, government employees are paid more than their private sector counterparts and the benefits of government employees are richer than those of private sector employees. In the private sector, DC benefits are the norm. Government jobs are more secure than private sector jobs.

Pension Plans. As noted previously, the employer contributions for the TRS for the fiscal year 2013 amounted to 11.41 percent of compensation. For the ERS, the employer contributions percentage was 14.90 percent of compensation for "Old Plan" and "New Plan" participants. (GSEPS participants received

[35] The Economist edition listed Nebraska's accrued pension liability as last among the 50 states, at 7 percent of its revenues. In contrast, the liability of Illinois (the worst, in terms of funding ratio), was 241 percent.

[36] "Kentucky's Successful Public Pension Reform," State and Consumer Initiatives, The Pew Charitable Trusts, September 2013

a lower percentage, 11.54 percent, but they could also participate in a DC plan providing up to 3 percent employer matching contributions if 5 percent of more of pay was contributed.) The contribution rates will increase this year and next year.

With the exception of professional firm employers (such a physicians' practices and law firms), where the professionals receive very large contributions and the staff receive significant contributions because the non-discrimination rules of the Internal Revenue Code §401(a)(4) regulations so require to preserve tax-qualification, these large percentages are virtually unheard of in the private sector. A typical private sector employee is lucky if the total employer contributions for his benefit equal 6 percent of his compensation. Often, the employer contributions are provided through matching contributions to a 401(k) plan. As noted above, on average, public pensions provide more retirement income benefits than those provided by private sector plans (even when Social Security is included). Georgia is no exception.

Given that both the TRS and ERS are relatively rich in terms of benefits provided, prospectively changing the retirement benefits system could be a way to reduce the benefits inequity. Some options follow.

The following discussion assumes that, similar to ERISA, Georgia law protects only accrued benefits. Otherwise, the following options *do not exist* except with respect to employees hired in the future.

Termination of existing DB plans using low interest rates (in the current low interest rate environment) would produce large lump-sum benefits that could not realistically be funded by current taxes.[37] The TRS and the ERS have no substantive termination provisions. Thus, legislation would very likely be required to terminate either one of these plans. Given the low current interest rate, termination now would mean relatively high benefit payments (if a lump-sum was payable or an annuity was purchased).

Realistically, a change to a DC system or any other system could only be made going forward. And, existing benefits would need to be "frozen," meaning they would not grow further (except perhaps for reasonable COLAs[38]). In the case of a switch to a DC system, existing retirees would not be impacted, current employees would receive part DB/part DC benefits upon retirement and future hires would receive only DC benefits.

Assuming prudent asset management and sufficient contributions in the future, the DB plans of the state of Georgia should be able to provide the benefits accrued to date.[39] OPEB in Georgia is another story. Unless the medical benefits are replaced in a financially affordable and legally solid manner, in order to avoid significant funding problems in the future, funding will have to begin in the near future and be consistently done in substantial amounts to fund what has been promised.

If the goals of the Legislature are to reasonably reduce retirement benefits (possibly to help reduce disparity between private sector and public sector pay), provide enough benefits to fund a significant part of a reasonable retirement, provide for matching of taxes to currently earned compensation of employees

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[37] Ordinarily, when a private sector DB plan is terminated, and a lump-sum option exists, earned future annuity payments are discounted to present value using a PBGC-specified interest rate to produce the lump-sum amounts. With respect to annuities, the plan administrator ordinarily purchases an annuity from an insurance company to pay benefits. In a governmental situation, it may be that annuities could simply be paid by setting money aside from other governmental assets in the future as necessary to pay future benefits.

[38] It would be reasonable to include reasonable COLAs. There is a very good chance that future inflation will exceed 3 percent for many years. It may be necessary to analyze excessive COLAs in the past in light of future inflation (as experienced) and find a balance in terms of a fair COLA.

[39] Assuming a willingness to greatly increase future contributions, the existing DB benefits could be continued indefinitely. Query whether Georgians are willing to pay more taxes or receive less services in other areas to continue the existing DB system indefinitely, given that state employees are generally paid more than, and have more job security than, their private sector counterparts. The DB formula could instead be reduced prospectively (e.g., by reducing the accrual percent to 1.5 percent), but the potential for IBG-YBG, the possibility of cronyism, and the lack of matching of taxes to earned income expenditures would remain.

and prevent the possibility of “IBG, YBG,” thought should be given to using one plan with two components for all employees.

One component would provide a fixed contribution that is fully funded by the employer and the other component would provide for elective deferrals and matching contributions.

Social Security considerations are difficult: Some of the TRS and ERS participants participate in Social Security, others have participated in the past and some former employees who will be entitled to a Georgia pension now work in the private sector and participate in Social Security. Sometimes, a spousal or survivor’s benefit is payable. (Many combinations exist.) Most economists believe employees bear the burden of the employer’s share.[40] In any event, any change should be reasonably progressive to deal with the possibility of no Social Security benefits.

An example of what the author believes is a reasonable option follows. A plan could be established with a money purchase pension plan (MPPP) feature and a 401(k)-like feature. The MPPP would provide for a $2,000 annual contribution that grows annually with inflation by the CPI for the preceding year plus a 2 percent of compensation allocation. Five-year cliff vesting would apply.

The 401(k)-like feature would be the current GSEPS 401(k) plan with three changes:

(a) Each participant would be required to defer 3 percent of compensation
(b) The 50 percent match would be extended from 5 percent to 6 percent of elective deferrals
(c) A five-year cliff vesting schedule would apply.

The $2,000 fixed contribution would be pro-rated for part-time employees.

In such a case, a full-time employee earning $30,000 per year would receive an employer MPPP contribution equal to 8.7 percent of compensation (i.e., (2,000 + (30,000 x .02))/30,000). A participant earning $100,000 per year would receive an employer MPPP contribution equal to 4 percent of compensation.

If the employee earning $30,000 per year deferred 6 percent under the GSEPS, a total of $5,450 would be “put away” for retirement (i.e., 18.2 percent of pay), of which $3,650 (i.e., 12.2 percent of compensation) would have been supplied by the employer/taxpayers.

If the employee earning $100,000 deferred 6 percent under the GSEPS, a total of $13,500 (or 13.5 percent of compensation) would be put away for retirement, of which 7.5 percent would have been supplied by the employer/taxpayers.[41]

Assets could be professionally managed, except employees could be given the option to direct investment of some or all of their GSEPS accounts.

To reduce administrative costs, both TRS and ERS employees could participate in this plan and any needed compensation adjustments to produce fairness could be made outside the plan.[42] As noted, a DC plan fits well with the Georgia Constitution’s requirement that the budget be balanced annually. *Assuming unfunded accrued liabilities did not exist upon a freeze*, making these changes in conjunction with a freeze of the TRS and the ERS would produce approximately $600 million of savings in the fiscal year

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[40] See the Tax Policy Center of the Urban Institute and the Brookings Institution website posting at www.taxpolicycenter.org/taxtopics/Payroll-Taxes.cfm. Generally speaking, the lower an individual’s average earnings, the better of an investment is Social Security. The extra cash that exists in a paycheck due to lack of Social Security participation adds to personal wealth.

[41] Employees would not be limited to deferring 6 percent of pay. The annual limit for elective deferrals for 2014 is $17,500, plus an additional $5,500 if the employee is age 50 or greater at any time during the plan year.

[42] The frozen TRS and frozen ERS could be merged, to save on administrative costs.

beginning in 2014.[43] Greater savings would be produced thereafter. For 2015, the savings prior to amortization of the unfunded accrued liabilities would be approximately $825 million.[44] To the extent unfunded accrued liabilities remained after a freeze, these liabilities would need to be funded over time.[45]

An additional benefit of a DC (or cash balance) change would be greater attractiveness to young employees…

Given the limited information provided in the 2013 financial statements of the TRS, it is very difficult to gauge the annual contributions that would be necessary to finance the remaining unfunded accrued liabilities of both the TRS and the ERS. However, assuming 30-year amortization, the annual funding requirement would be in the hundreds of millions of dollars, perhaps even as high as $600 million.

While the immediate savings from a change might not be tremendous, the change would eliminate all of the negatives previously discussed with respect to DB plans and make Georgia retirement benefits more like private sector benefits.

In lieu of the MPPP, a cash balance plan might be created to reduce risk to participants. However, in such a case, to fairly compensate for reduced risk to participants (and commensurate greater risks for taxpayers), the annual contribution rate should be slightly lower than the MPPP allocation rate. Given that cash balance interest credits are usually relatively low, it would seem that any risk adjustment should be small. For example, if the cash balance interest credit rate was 5 percent, the risk reduction might be 5-10 percent. A 7.5 percent reduction would reduce the fixed contribution from $2,000 to $1,855 and the percentage contribution rate from 2.0 to 1.855. If a cash balance plan approach was used, annual funding should match annual compensation credits and interest credits unless and until the plan is substantially overfunded (in which case funding could be reasonably reduced).[46]

Assuming there would be no unfunded accrued liabilities after a freeze (see prior discussion), making these changes (instead of using a MPPP) in conjunction with a freeze of the TRS and the ERS would likely produce approximately $660 million of savings in the fiscal year beginning in 2014. Greater savings would be produced thereafter. However, taxpayers would bear the investment risk. Perhaps employees could be permitted to choose between a MPPP and a slightly less rich cash balance plan.

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[43] The following assumptions were made: TRS payroll of $11 billion, ERS payroll of $2.4 billion and an average elective deferral rate of 4 percent. Other figures (e.g. participant totals) were taken from the financial statements of the TRS and the ERS. In addition to the TRS and the ERS, all other small plans maintained by the state could also be transitioned to the new system.

[44] As noted, for 2015, the respective expected employer contribution rates for the TRS and the ERS are, generally speaking, 13.15 percent and 19.8 percent. (19.8 percent is a weighted average blend of the three rates noted *supra*.) Using these rates, and assuming 2015 payroll of $11.5 Billion for the TRS and $2.6 Billion for the ERS, the 2015 savings prior to consideration of amortization of the unfunded accrued liabilities would be approximately $825 Million.

[45] The extent to which any such funding should be provided by teachers and state employees, instead of by the state, is beyond the scope of this article. However, if certain individuals received a windfall (e.g., because a buy-in of service for service worked in another state was below a reasonable actuarial charge), it would seem that such individuals should contribute part of the necessary funding over time to a reasonable degree to correct the windfall.

[46] While future returns for any investment are unknown, most analysts believe that public sector plan fiduciaries and administrators are being overly optimistic in terms of future investment return assumptions. For example, in his September 10, 2013, article titled "Pensions Are Still Making Ludicrous Assumptions about Future Returns," John Mauldin noted: "Many state-funded pension plans today assume an 8% nominal rate of return for the indefinite future. ... Moody's argues that somewhere in the range of 4% nominal is more realistic." It seems likely that the fiscal problems of governments around the world and the maturing of the economies of heavily populated countries will wear on investment returns, but inflation could create positive paper returns.

An additional benefit of a DC (or cash balance) change would be greater attractiveness to young employees for reasons already noted. In this regard, a January 23, 2013, article by Steve Metz for the Georgia Public Policy Foundation titled, "The Case for Reforming Georgia's Teacher Retirement System," notes the recruiting, job lock and other detriments of the current DB approach.

Some large companies continue to provide post-retiree medical benefits, and some union employees receive them. However, in the private sector, they are the exception rather than the rule.

Much greater employer-funded DC benefits could be provided than those outlined above to enhance retirement benefits. However, if non-teachers generally are comparatively overpaid in terms of total compensation and the goals are to place state compensation more in line with private sector pay for non-teachers partially through retirement reductions and to reasonably reduce teacher's retirement benefits while moving to a DC system, the above proposal would work. Otherwise, at least with respect to any non-teachers who are overpaid, cuts to compensation should be made elsewhere to reduce unfairness. No cuts will be welcome by any employee.

One of the benefits of the proposal outlined above is the cessation of a lifetime commitment (i.e., over the life of the employee) by taxpayers. With life expectancies only increasing in recent years, such a change limits the exposure of taxpayers while forcing taxpayers to pay for the amount currently earned.

For the reasons noted, the Legislature should be able to change the law to make such changes. (Whether freezing accrued benefits and installing reasonable reduced benefits going forward would pass muster can only be known if implemented, challenged and then decided upon by a court of law.) At a minimum, a conversion to a system along the lines of that described above should be made for all newly hired employees.

OPEB. A minority of private employers provide OPEB of any nature. In September 2013, both IBM and Time Warner announced elimination of OPEB for most of their U.S. retirees, coupled with contributions to health reimbursement arrangements.[47] Some large companies continue to provide post-retiree medical benefits, and some union employees receive them. However, in the private sector, they are the exception rather than the rule.

Assuming it is legally possible, an option here is complete elimination of the current OPEB system prospectively, while using high-deductible health plans (HDHPs) for health insurance for *all* employees, coupled with HSAs.[48] According to an Atlanta Journal-Constitution article dated January 12, 2014, all Georgia employees and teachers were transitioned to such plans after 2013. However, according to a later *Atlanta Journal-Constitution* article, after an uproar by employees, the transition was largely reversed.

A HDHP forces employees to try to control health care costs. The popularity and use of HDHPs has grown tremendously in the private sector in recent years. The maximum annual out-of-pocket payment under HDHPs described in Internal Revenue Service Code §223 for 2014 is $6,350 for a single person and $12,700 for a family. The more HDHPs/HSAs catch on, the more pressure will exist to induce competition among providers, thus eventually pressuring annual health care cost increases to fall in line

[47] Generally speaking, a health reimbursement arrangement is an arrangement where money is allocated for use by an employee for health care during a year.

[48] An HSA is a health savings account, as defined in Internal Revenue Code § 223. It is similar to an IRA except withdrawals for health care purposes are tax-free.

with cost increases in all other services.[49] Employees ordinarily can elect to contribute part of their compensation to their HSA accounts, to save for current and future health care costs. Reducing health care costs will help all employees outside those in the health care arena.

If the facts show that OPEB can be changed to any degree and the desire exists to fairly eliminate OPEB going forward, existing employees could be grandfathered in their current benefits to the percentage their current years of service bears to 30 (meaning a double pro-ration would apply to people falling under the new OPEB system). Existing retirees would not be impacted. In lieu of a prospective complete elimination, a reasonable annual contribution (e.g., $1,500) could be made to HSAs of full-time employees (assuming all employees were placed in a HDHP) to help pay for post-retirement medical costs.

Conclusion

The baby boom is showing the frailties of democracies in the United States and abroad. Voters generally vote for the candidates promising the most and taking the least. All three layers of government in the United States – local, state and federal – will be tremendously stressed over the next 15-plus years. If all who can will reasonably sacrifice, all systems can be preserved.

Georgia can position itself to be competitive for business in the future by getting its retiree benefits obligations under control. A defined contribution or cash balance approach to retirement benefits is the best means of fairly tying taxes to current work performed, providing certainty, and eliminating "IBG, YBG."

[49] A September 2, 2013 Bloomberg article by Lanhee Chen titled “Health Savings Accounts an Antidote to Obamacare” provides: “About 11 percent of workers in employer-sponsored plans are enrolled in an HSA-qualified plan, up from 2 percent in 2006. .... A 2012 study by the RAND Corp., benefits consulting firm Towers Perrin and the University of Southern California concluded that annual health-care spending could be reduced by $57 billion if consumer-directed health plans accounted for half of employers’ plans.” (An HSA coupled with an HDHP is a consumer-directed health plan.)