

education sector policy briefs

A Legal Guide to State Pension Reform

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and Bill Tucker



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Just 18 minutes before the midnight signing deadline on May 15, 2010, Minnesota state legislators breathed a sigh of relief. Their bipartisan pension reform legislation, which passed both chambers by large margins and aimed to help shore up a potentially failing pension system, had just escaped a veto threat. Under pressure from his Republican legislative allies, Gov. Tim Pawlenty signed the omnibus pension bill into law.¹ The relief, however, was short-lived. Fewer than 48 hours later, two retired Minnesota state employees filed a class action lawsuit, claiming that by reducing cost-of-living adjustments, the state had violated contractual rights to promised benefits. As a result, the courts, not the legislators, would have the final say.

Minnesota is just one of many states confronting massive pension shortfalls. According to the Pew Center on the States, unfunded state pension obligations total more than \$1 trillion and exceed thousands of dollars per resident in many states. If states don't act to rein in pension liabilities, state contributions will eat up an increasingly greater share of revenues, crowding out funding for everything from repairing roads and providing social services to hiring and retaining high-quality teachers and principals.² To avoid this threat, 39 states have made significant changes to public pension plans in the last two years.³ And many more changes are under consideration.

But pension reform is not just a financial, ethical, educational, and political issue. It is also a legal issue. And a complicated one at that. As states across the nation wrestle with pension reform, they must strike the right balance in navigating legal constraints, which are often either overlooked in public discussions or overly feared by those involved. States that ignore legal precedents and constitutional protections will find themselves on the losing end of costly court battles. Those that are too timid and tinker only at the edges may also suffer by allowing pension problems to fester and grow. But those that find the right balance, like Minnesota managed to do, can overcome court challenges. The state's Second

Judicial District Court ultimately dismissed the case, upholding the reduction in the cost-of-living adjustment (COLA).⁴

This brief offers a broad overview of the legal issues that policymakers must confront. State pensions are protected under laws that vary considerably from state to state. Thus, we profile four states (California, Illinois, New Mexico, and Ohio) to provide a representative sample of the range of protections mandated under state law.

The Legal Landscape

State laws on pensions have evolved over the past century. Historically, public employee pensions were considered by states to be mere "gratuities" that could be amended or withdrawn at any time. Beginning in the early 20th century, however, many states began to reject the gratuity approach and embrace other legal approaches that protected workers from arbitrary changes to pension plans. Today, states protect pension plans under laws that vary considerably from state to state. While two states, Indiana and Texas, still follow the gratuity approach in limited circumstances, most state pension protections fall in two broad categories:

contract or property interest. (See Sidebar, “Types of Legal Protections.”)

States that take a contract approach to state pensions generally provide the strongest legal protections against changes. Under the U.S. Constitution, states cannot typically take actions to impair contracts. Absent extraordinary circumstances, benefits covered by a contract cannot be changed to an employee’s detriment. And the details of those contracts, which vary from state to state, matter greatly.

In California, for instance, the contract begins on the date the employee is hired. As a result, states that follow what is known as the “California Rule” prohibit any reduction in benefits for current employees, even those benefits that are merely potential or yet to be earned. Adopting a new benefit calculation is impermissible if it results in a single participant receiving a lower benefit than they would have received under the old formula. In Ohio, on the other hand, the contract begins after five years, i.e., when the employee is vested, or eligible for retirement benefits; the benefits of newer employees are not protected. Almost all states, however, including California and Ohio, safeguard retirees’ benefits.

A handful of states use the property interest approach. This approach, which generally provides

fewer protections, equates retirement benefits with a property right that can be taken away—but only with due process of law. In 1998, New Mexicans voted to approve a state constitutional amendment that provides a property interest protection for public employee pensions once employees meet minimum service requirements. The amendment, however, allows for modifications to retirement plans that enhance or preserve the plan’s actuarial soundness—a significant loophole in the protection otherwise granted. When weighing the viability of pension reform legislation, it is critical to understand a state’s specific provisions and legal precedents. Still, in most states, the law is not fully settled or is highly fact-dependent, meaning that many of these provisions are open to interpretation by the state’s courts.

How Legal Protections Constrain Potential Pension Reforms

While legislators in almost every state have been actively reforming state pension plans, it is likely that the next round of reforms increasingly will spark legal conflict. Past state reforms, such as those that address abuses like “spiking,” where an employee’s compensation is artificially inflated in his last years

Types of Legal Protections for Public Employee Pensions

The legal protections provided to public employee pensions are a matter of state law, and therefore vary significantly among the states. Below are the primary types of protection:

- **Contract protection:** In some states, the state constitution contains a specific provision addressing public employee pensions. These provisions generally provide that such pensions are entitled to contractual protection, but vary with respect to whether they protect only accrued benefits or also include protection for benefits not yet earned. In other states, the state constitution is silent on public employee pensions, but state courts have ruled that such pensions create a contract between the state and the employee. States adopting this approach also differ significantly in the protections offered. In some states, a contract protects both past and future accruals and is considered to be created on the first day of employment, whereas in other states only past accruals are protected, and only once a participant has vested.
- **Property protection:** In a minority of states, state courts have held that public employee pensions create not a contract, but a property right prior to retirement. A property right is a right that is protected by procedural due process requirements (generally meaning that participants have a right to notice and comment on proposed changes) and also protected against arbitrary and capricious government action. This offers relatively little protection to participants prior to retirement.
- **Gratuity:** Only two states, Indiana and Texas, continue to adhere to this approach, which characterizes public employee pension as gratuities that can be withdrawn or amended at any time and for any reason. These states adhere to the gratuity approach only in limited circumstances and not for all public employee pensions.

of employment to pump up pension benefits, are important, but usually insignificant when compared to total pension shortfalls.⁵ Alternatively, many states, such as Maryland, have increased employee contribution rates for current and future employees to address shortfalls. But, given the depth of state pension finance woes, legislators are realizing that they must make more fundamental changes.

One option that avoids both legal and political conflicts is to inflict pension changes only on future hires, slashing, for example, new teachers' pensions and using their contributions to subsidize current teachers and retirees. But Illinois' experience shows why this approach may not only fail to solve a state's financial problems, but more important, could rob its future—in this case by making it more difficult for schools to recruit new teachers.

Given the depth of state pension finance woes, legislators are realizing that they must make more fundamental changes.

In Illinois, the Legislature's 2010 reforms divided the state's teachers into those hired before January 1, 2011, and those hired after. The new teachers pay at the same level of contribution (9.4 percent) as those hired before 2011, but they have significantly reduced pension benefits. Under these reforms, new teachers, teachers that move across state lines, and career-changers all relinquish significant pension wealth. A new, 25-year-old teacher in Illinois will not break even on her contributions until she is 51 years old and has taught for 26 years, explain pension experts Robert Costrell and Michael Podgursky in the journal *Education Next*.⁶ If that same teacher decides to stop teaching in her 30s or 40s, she will not receive any employer contributions.

Pension reforms that aim to reduce accrued benefits—those already earned by an employee—are the most challenging reforms to pass, defend, and implement. In most cases, a state that does not deliver promised benefits faces a strong legal challenge. When lawmakers cannot reduce accrued

benefits for political or legal reasons, they often limit the COLA, an annual increase in benefits to balance the increased cost of living over time. Most state pension plans include a COLA. Over time, the COLA can represent significant costs to the state pension plan, especially for public employees who retire in their 50s and live into their 80s. Last year, Hawaii reduced the COLA for new employees from 2.5 percent to 1.5 percent, a seemingly minor change that will result in significant cost savings in the long term. While COLA reductions can result in significant cost savings for a state, the ability to make such changes for current employees and retirees varies significantly from state to state.

Navigating Legal Constraints

Policymakers' hands, though, are not completely tied by existing legal limitations. And, there are some measures of reason even in the strictest states. All states allow changes to policies that affect pensions but aren't actually part of the benefit calculation. So even in places with strict protections like New York and Illinois, the state can reduce salary levels, terminate employment, or take other actions that would reduce an employee's pension, as long as they don't change the pension formula itself.

To increase their chances of successfully implementing pension reform, legislators can draft compromise measures that phase in changes over time. Consider this federal example: In 1983, lawmakers decided to increase the retirement age for Social Security from 65 to 67. To limit opposition and improve their legal argument for the change, the legislation required delaying implementation until 2000, and then, only increasing the retirement age gradually. The final effect of the law—moving the retirement age to 67 for all workers—won't be in place until 2027.

In states that take the contract approach to pension benefits, it may be possible to change the way the court views the contract. Current case law may interpret the contract as protecting all current and potential benefits over the course of an employee's lifetime. An alternative argument, however, would be that the contract protects benefits as they are earned but does not protect future benefits associated with future service.

Policymakers may also be able to use the state’s “police power” to justify changes to the pension system. Police power refers to a state’s power as a sovereign to act to protect the health, safety, and welfare of its citizens. Even where the state is bound by a contract, it always retains its police power.

However, where a state seeks to rely on its police power to substantially impair a contract to which it is a party, the U.S. Supreme Court has held that the court must establish that the impairment is reasonable and necessary to serve an important public purpose, “such as the remedying of a broad and general social or economic problem.”

To show that a change is necessary, the state must establish that no less drastic modification could have been implemented to accomplish the state’s goal, and that the state could not have achieved its public policy goal without modification. The legislation should first document the compelling need for the change. When Rhode Island passed pension reform legislation last fall, for example, the first section of the bill was dedicated to a 16-point description of the state’s financial crisis.⁷ The Rhode Island legislation declares that the state’s pension system has reached an “emergency state,” proposes a temporary adjustment, and seeks to share the burden across current employees, retirees, and taxpayers.

The recent ruling from Minnesota offers another example. Here, the plaintiffs, former state employees, claimed that 2010 legislation, which reduced the yearly COLA for retirees, violated their contractual rights. But, in a June 2011 ruling, the state’s Second Judicial District Court dismissed the case.⁸ The court held that the state was permitted to temporarily reduce the COLA for public employee pensions as part of a broad plan to address plan underfunding pursuant to its police power. In upholding the COLA reduction, the court noted that all interested parties (current employees, retirees, the state, and the taxpayers) were sharing the burden associated with remedying the plan’s underfunding, and that the court was hesitant to interfere with the apparently reasonable legislative judgment regarding the preferred method for addressing such underfunding. The court rejected the argument that the state needed to pursue other remedies, such as raising taxes, before reducing retirees’ COLAs.

Despite the Minnesota case and a similar ruling in Colorado, there are still very few cases addressing detrimental changes to public employee pensions where the court has found a substantial change to be a valid exercise of a state’s police power. And, there is no objective test that is used to determine whether a state may validly exercise its police power. Rather, it is always a fact-intensive, case-by-case inquiry.

Table 1. Comparison of Pension Protections in Four States

State	Type of Protection	Changes to Benefits Already Earned	Changes to Future Benefit Accrual	Changes to Cost-of-Living Adjustments
California	Contract; rights vest on first day of employment	Cannot be reduced or eliminated	Cannot be reduced or eliminated	Cannot be changed to the employee’s detriment
Illinois	Contract, by 1970 constitutional amendment; rights vest on first day of employment	Cannot be reduced or eliminated absent extraordinary circumstances	Courts have not ruled, but benefits are likely protected against detrimental changes	Courts have not ruled, but changes not allowed in other states where pensions are protected on first day of employment
New Mexico	Property, by 1998 constitutional amendment; once minimum service requirements are met	Likely cannot be reduced once minimum service requirements are met; changes may be permitted that enhance or preserve actuarial soundness	Uncertain, but likely that changes would be permitted	Courts have not ruled; other states have come to mixed conclusions
Ohio	Contract; once a participant has fulfilled necessary conditions to receive a pension	Cannot be reduced or eliminated if retirement benefit granted	Yes	Likely cannot be reduced or eliminated if retirement benefit granted

California

Like nearly every other state, California initially treated public employee pensions as gratuities that could be amended or withdrawn at any time. In the 1940s, however, California courts moved away from the gratuity theory and began protecting public employee pensions under a contract theory. Today, California courts use one of the most protective approaches to public employee pensions in the country. As a result, under existing California Supreme Court rulings, very few changes would be permissible for any current employees.

Under the California and federal constitutions, a state may not, generally speaking, take actions that significantly impair a contract. Legislators, therefore, that desire to make changes to pension benefits for current public employees have just three options: the first is to rely on its police power to make changes that are reasonable and necessary in order to serve an important public purpose, and the second is to make changes and attempt to convince a court that existing law in the state of California should be either clarified or overturned. Both of these options come with significant burdens and uncertainty.

The final option is to amend the state constitution through a ballot proposition. While a ballot proposition solves some of the problems in California—particularly the political one (voters may be willing to change pension plans when legislators are not)—it is not a guarantee of legal success. Legally, it could solve the California constitutional issue (by amending the constitution to provide that it is okay to make prospective pension changes under California’s Constitution). We say it “could” because, to the extent that the right to a pension is considered vested under California state law, it isn’t clear that a ballot proposition works to amend the constitution to take away that right. But even if we assume that a constitutional amendment solves the California state law claim, participants would still be able to bring a federal constitutional claim. Federal courts are much more likely than California state courts to find a prospective change permissible, but the outcome is not certain for a variety of reasons. A ballot measure to amend the constitution increases the chance for success but doesn’t guarantee it.

Pension Protections in California

Type of protection: Contract; rights vest on first day of employment

Changes to benefits already earned: Cannot be reduced or eliminated

Changes to future benefit accrual: Cannot be reduced or eliminated

Changes to cost-of-living adjustments: Cannot be changed to the employee’s detriment

How Does California Law Protect Public Employee Pensions?

To date, California courts have held that the contract is formed as of the employee’s first day of employment, and thereafter the pension is subject only to “reasonable modifications.” To be considered reasonable and thus permissible, the change must bear a material relation to the “theory of a pension system,” and any disadvantages to participants have to be balanced by “comparative new advantages.” Further, the contractual protection is treated as open in duration, beginning on the first day of an individual’s employment and extending for as long as an individual works for the state. In other words, not only are benefits that have already been accrued protected, but the court has also interpreted the protection to apply to the future rate of benefit accrual.

Can Benefits That Have Already Been Earned Be Reduced?

For current employees, it is clear under existing California Supreme Court opinions that changes to benefits that have already been earned can be reduced only if the change is consistent with the theory of a pension system and where any resulting disadvantage to a participant is offset with a comparable new advantage. As a result, pension benefits that have already been earned through services rendered to the state cannot be reduced or eliminated. The only exception to this rule would be if the state could justify the change under its police power—a difficult standard to satisfy when it comes to benefits that have already been earned.

Can Benefits Be Changed for Future Years of Service?

The California Supreme Court has taken the position that future benefit accruals are protected on the same basis as benefits that have already been earned and are subject to the same test outlined in the previous section. For example, assume a current state employee earns pension benefits at the rate of 2.5 percent of salary per year. Under existing California law, the state would not be permitted to lower that rate of accrual with respect to future service (i.e., service not yet performed) unless the reduction is offset by a comparable new advantage or unless the change is justified under the state's police power.

It should be noted, however, that California is an outlier when it comes to the protection of future benefit accruals, and several commentators have argued that future accruals should not be granted the same legal protection as benefits that have already been earned. Nonetheless, current California Supreme Court rulings do protect such accruals, and a future court would have to differentiate or overturn those existing rulings to reach a different result.

What About Cost-of-Living Adjustments?

California courts have consistently held that cost-of-living adjustments (COLAs) are part of the pension benefit that is protected as of the first day of employment. As a result, once an employee begins work in a pension-eligible position, any COLA in place

at that time cannot be changed to the employee's detriment. California courts have specifically held that this protects not only COLAs that relate to benefits already accrued, but also to COLAs for future benefits. Assume, for example, that when an employee began work for the state in a pension-eligible position, the law provided for a 3 percent annual COLA. If, after the employee had worked for

California courts have consistently held that COLAs are part of the pension benefit that is protected as of the first day of employment.

10 years, the state desired to reduce or eliminate the COLA, it would be unable to do so, not only for the pension benefits the employee had accrued during the 10 years she had already worked, but also for any amount of time she might continue to work for the state. Under existing California state law, the only valid methods to detrimentally change COLAs would be if a detrimental change to a COLA was offset by a comparable new advantage, or if the change was justified under the state's police power. To date, there have been no cases in California allowing detrimental changes to public employee pensions based on the state's police power.

California's Teacher Pension System At-a-Glance

California's public school teachers receive their pensions through the California State Teachers Retirement System, or CalSTRS. CalSTRS mainly consists of a defined benefit plan, although some teachers participate in a Defined Benefit Supplement program too. CalSTRS also offers a cash balance plan to part-time educators and a supplemental savings plan, Pension2. California's current liability for all its public employee pensions—estimated at nearly half a billion dollars—is the highest in the country.

CalSTRS Defined Benefit Program¹

Employee contribution: 8 percent of "creditable compensation," which includes overtime

Employer contribution: 8.25 percent of creditable compensation

State contribution: Approximately 4.5 percent of creditable compensation

Vesting period: Five years²

Retirement eligibility age: Age 50 for teachers with at least 30 years of service credit; age 55 for teachers with at least five years of service credit

Cost-of-living adjustment: 2 percent³

(Continued on next page)

CalSTRS Defined Benefit Formula⁴

California's defined benefit pension is calculated according to a fairly typical formula:

Annual benefit = (Final compensation) x (Service credit) x (Age factor)

- **Final compensation** = Highest one-year "earnable compensation" for teachers who retire with at least 25 years of service credit; highest average earnable compensation over 36 consecutive months for teachers with less than 25 years of service credit.
- **Service credit** = Teachers receive one full year of service credit for each year in which they earned compensation for working full time.
- **Age factor** = Ranges from under 2 percent to 2.4 percent, depending on retirement age and years of service credit. If a teacher retires at age 60 with less than 30 years of service, her age factor is 2 percent. If she retires after age 60, it is increased to a maximum of 2.4 percent. A teacher who retires with at least 30 years of earned service credit can also see her age factor increase to a maximum of 2.4 percent. Teachers who retire before age 60, however, receive an age factor below 2 percent.

CalSTRS Defined Benefit Supplement Program⁵

Some teachers are also eligible to receive benefits through the Defined Benefit Supplement (DBS) program. The following provides a brief overview of the DBS program:

What is contributed to DBS accounts? From 2001 to 2010, one-quarter of each employee's contributions (2 percent of salary) were deposited in DBS accounts. The remaining 6 percent went toward the regular defined benefit program. From January 2011 onward, DBS accounts only can receive contributions from (1) an employee's earnings in excess of one year of service credit (i.e., if the employee works more than full time, as defined by collective bargaining or employee agreement), and/or (2) special compensation for some members.

How are funds invested? DBS funds are invested in internally pooled portfolios. They earn interest at a rate

set by the Teachers' Retirement Board at the beginning of each fiscal year (July 1). The rate, which is based on the 30-year U.S. Treasury rate, was 4.5 percent in the 2010-11 fiscal year.

How are benefits distributed? Upon retirement, the teacher can receive DBS funds in one of three ways: (1) as a lump sum, (2) an annuity, or (3) a combination of these two options.

Legislative Action in 2011

California did not pass any pension reform legislation in 2011.⁶ In February 2012, Gov. Jerry Brown submitted a pension reform proposal to the Legislature. The plan includes raising the retirement age to 67 for most government workers, creating a new "hybrid" plan that is part defined benefit and part 401(k)-type plan, and raising employee contributions. As of this writing, a joint Senate-Assembly Committee is working to draft a bill.⁷

Notes

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6. Ronald K. Snell, "Pensions and Retirement Plan Enactments in 2011 State Legislatures," National Conference of State Legislatures, January 31, 2012.
7. "Editorial: Pension Reform Teeters, So Brown Needs a 'Plan B'," *Sacramento Bee*, January 13, 2012.

Illinois

In Illinois, as in most states, pension protections have evolved over the decades. Early state cases agreed with the position that public employee pensions are gratuities, giving the state the freedom to amend or withdraw benefits at any time. In 1970, however, Illinois incorporated into its state constitution a specific provision protecting public employee pension benefits. Illinois courts have provided some guidance through the years regarding the scope of this constitutional protection, but significant uncertainty remains.

Still, despite this uncertainty, Illinois' public employee pensions enjoy strong protections overall. Attempts to reduce accrued benefits would be considered a "substantial impairment" of such benefits, and the state would have a difficult burden to meet in justifying such a change. Even though it is less clear how Illinois courts would approach changes to future benefit accruals, changes to future benefits would be easier to justify than those to accrued benefits. The vulnerability of cost-of-living adjustments (COLAs) is also unknown and would depend in part on whether the court considered COLAs to be part of a participant's accrued benefit or rather a future benefit.

For Illinois policymakers who want to make changes to public employee pensions to improve the plans' financial conditions, the best course of action would be to (1) thoroughly study the existing financial conditions of the plans and (2) based on that study, model various scenarios of pension plan changes to determine which is best suited to address the situation, keeping in mind that the accrued benefits are entitled to the greatest legal protection. While no one can predict a court's response to given changes, cases in other jurisdictions suggest that methodically examining the pension fund's needs and modeling various options to determine the most reasonable course of action gives the state the greatest likelihood of surviving a legal challenge.

How Does Illinois Law Protect Public Employee Pensions?

Illinois is one of a handful of states that has included in its state constitution a specific provision addressing public employee pensions. Section 5 of Article XIII

Pension Protections in Illinois

Type of protection: Contract, by 1970 constitutional amendment; rights vest on first day of employment

Changes to benefits already earned: Cannot be reduced or eliminated absent extraordinary circumstances

Changes to future benefit accrual: Courts have not ruled, but benefits are likely protected against detrimental changes

Changes to cost-of-living adjustments: Courts have not ruled, but changes not allowed in other states where pensions are protected on first day of employment

of the Illinois Constitution provides, "Membership in any pension or retirement system of the State or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." As a result, unless there are rather extraordinary circumstances, benefits covered by the contract cannot be changed to a participant's detriment. This is because under the Illinois and federal constitutions, a state may not, generally speaking, take actions that significantly impair a contract.

There are, however, two important caveats to this seemingly strong protection for public employee pensions. First, the protection only applies to those things considered to be included in the contract between state and employee. Courts in Illinois have held that the constitutional provision creates a contract at the time an employee first becomes eligible to participate in the retirement system, which means that the protection begins immediately upon employment in a benefits-eligible position. In addition, if the state makes any beneficial changes after the employee began participating in the retirement system, those changes are considered to be part of the contract as well and are therefore also protected by the Illinois Constitution. But Illinois courts have found that changes to the terms and conditions of employment that have only an indirect effect on pension benefits are not included in the constitutional protection of pension benefits. Thus, the state is free to change an employee's salary or enact a mandatory retirement age, even though such actions may result in a reduced pension for an employee. Also, Illinois

courts have held that there is no constitutional protection with respect to the funding of a retirement system. Rather, all that is protected are the benefits themselves, and funding changes are permissible. As a result, public employees have no recourse to force the state to address funding shortfalls as long as the fund has sufficient assets to pay currently due benefits. The second important caveat to the general rule that public employee pensions cannot be detrimentally changed in Illinois is the state's ability to make changes where such changes are a valid exercise of the state's police power.

There are no reported cases in Illinois where detrimental changes to public employee pensions have been allowed based on the state's police power.

There are no reported cases in Illinois where detrimental changes to public employee pensions have been allowed based on the state's police power. In one case, the state tried to argue that it was permitted to amend the terms of the judicial retirement plan to calculate pensions based on average salary over a judge's final year of employment, rather than the judge's rate of pay on his or her last day of work. In denying that this change was a valid exercise of the state's police power, the court noted that although the system was underfunded, there was no indication that judges retiring shortly after a pay raise were a cause of the system's underfunding. This reasoning suggests that courts will pay attention to whether the solution proposed by the Legislature matches the cause of the problem that justifies use of the police power.

Can Benefits That Have Already Been Earned Be Reduced?

It is clear from the constitutional provision, and from judicial interpretations of that provision, that benefits that have already been earned by public employees may not, absent extraordinary circumstances, be

reduced. Assume, for example, that a current state employee has accrued pension benefits for 10 years at a rate of 2.5 percent of salary per year. Could the state retroactively change the rate of accrual to be 2 percent of salary per year? Only if doing so is considered a valid exercise of the state's police power.

Benefits that have already been earned, therefore, are entitled to contractual protection under state law, meaning they cannot be substantially impaired except where reasonable and necessary to achieve an important public purpose. It is likely that any decrease in the monetary value of benefits that have already been earned would be considered by courts to be a substantial impairment, requiring the state to present a compelling case regarding why such an impairment is reasonable and necessary. There are no reported cases in Illinois, or in any jurisdiction providing similar constitutional protections for public pension benefits, where such retroactive changes have been held to be permissible.

Can Benefits Be Changed for Future Years of Service?

Illinois courts have never directly considered the issue of whether changes can be made to retirement systems that affect only potential benefits, or those to be earned in the future. Assume, for example, that a current state employee is accruing pension benefits at the rate of 2.5 percent of salary per year. Could the state change the rate of accrual, going forward, to be only 2 percent of salary per year? The legal answer is unclear.

It is possible that an Illinois court would allow such prospective changes, based on the assumption that if the employee continues to work for the state, he or she has consented to such changes and the contract is therefore validly amended. Given prior rulings, however, it seems more likely that Illinois courts would find even future benefit accruals to be protected against detrimental changes by the constitution.

Nevertheless, the state may be able to make such changes under its police power. As mentioned earlier, the court in determining whether a change is permissible examines the extent of the impairment. And prospective changes are considered to be much

less of an impairment than retroactive changes. Indeed, outside of Illinois, several courts have held that prospective changes should not be considered substantial impairments of contract. In any event, the state is likely to have a much easier time justifying prospective changes under its police power. Such accruals generally are protected at a lower level than retrospective changes.

What About Cost-of-Living Adjustments?

Illinois courts have never ruled on whether the state is permitted to reduce or eliminate COLAs with respect to public employee pensions. In states that protect public employee pensions as of the first day of employment, reductions in COLAs have often been held to be impermissible. This is not surprising where a state's courts have held that both already earned benefits and future accruals are protected.

In other states, detrimental changes to COLAs have been permitted. For example, in a recent case in Colorado, the court distinguished between "base" pension benefits, which are protected against impairment, and COLAs, which are not. With respect to COLAs, the court noted that participants could have no reasonable expectation with respect to a specific COLA amount and, absent clear and convincing evidence that the Legislature intended to create a contract for a specific COLA, there was no "contract" for a specific COLA that should be protected by the state or federal constitution.

Outside of the pension context, the Illinois Supreme Court has held that COLAs that had been specified by law, but not yet granted, could not be withheld with respect to judicial salaries. Like pensions, judicial salaries are specifically protected by the Illinois Constitution against diminishment. However, the protection of judicial salaries in the constitution is absolute and does not include the "contractual relationship" language, suggesting therefore that the state may not exercise its police power with respect to such salaries. In determining whether future COLAs could be withheld, the court found that judges had

a constitutional right to the COLAs that had already been promised. As a result, all future COLAs due during a judge's term of office had to be paid, despite the state's dire financial situation.

Under the federal law that applies to private employer retirement plans, it is clear that COLAs are considered to be part of the benefit that an employee accrues, or earns, and that it therefore cannot be retroactively taken away. For example, under federal law, if an employee was a participant in a pension plan for 10 years while the plan had a COLA in place, the plan could be amended to remove the COLA from the benefit to be earned in the future, but not with respect to the benefit already earned. If the employee worked for 10 years while the COLA was effective, and 10 years after the COLA was removed, only the part of the pension earned during the first 10 years of employment would be adjusted pursuant to the COLA.

It is difficult to predict how Illinois courts would approach changes to COLAs, in part because much would depend on the particular facts of the case. To the extent that the retirement system provides for a COLA during the time an employee works for the state, it seems highly likely that a court would consider the COLA to be protected under the constitutional provision protecting pension benefits generally. However, the extent of that protection would turn, in part, on how a court characterizes the nature of COLAs. One possibility is that a court would consider COLAs to be part of a participant's accrued benefit and therefore would be protected to the same extent as an employee's base pension amount. A second possibility is that a court might consider COLAs to be prospective benefits prior to the time an adjustment is actually granted. Under this latter approach, a state would have an easier burden to satisfy if it wished to make changes pursuant to its police power. Regardless of whether the change is considered retroactive or prospective, however, the state would need to establish that the change is reasonable and necessary to serve an important public purpose.

Illinois' Teacher Pension System At-a-Glance

Teachers in Illinois—excluding those in Chicago—participate in the Teachers' Retirement System (TRS), which offers its members a fairly typical defined benefit plan. Chicago's teachers are covered by a separate retirement fund. Recent reforms to TRS have split members into two tiers, Tier I and Tier II, based on when they joined TRS. Tier designation dictates various provisions related to benefits, including retirement eligibility age and cost-of-living adjustments.

Tier I vs. Tier II¹

Tier I teachers: Anyone who has TRS service credits prior to January 1, 2011.

Tier II teachers: Anyone who first contributes to TRS on or after January 1, 2011, and does not have any prior service credit from a pension system that has reciprocal rights with TRS.

TRS Defined Benefit Program²

Employee contribution: 9.4 percent of creditable earnings

Employer contribution: Typically 0.58 percent of creditable earnings, plus any contributions required for early retirement benefits, excessive sick leave, or large salary increases³

State contribution: Calculated as the amount required to bring TRS to a funding ratio of 90 percent by 2045, as a level percentage of teacher salaries each year, minus debt service on pension bond issued in 2003. In FY 2010, the state contributed more than \$2 billion to TRS, or roughly 60 percent of total contributions that year.⁴

Vesting period: Five years for Tier I teachers; 10 years for Tier II teachers⁵

Retirement eligibility age (for full benefits): Varies depending on tier and years of service. For Tier I teachers, it ranges from age 55 with 35 years of service to age 62 with five years of service. For Tier II teachers, it is age 67 with at least 10 years of service.

Cost-of-living adjustment: 3 percent compounded annually for Tier I teachers; the lesser of 3 percent or half of the annual increase in the Consumer Price Index, not compounded, for Tier II teachers

Maximum benefit: For Tier I members who started teaching before July 1, 2005, there is no maximum benefit. For Tier II and other Tier I teachers, the maximum is 75 percent of final average salary.

TRS Defined Benefit Formula⁶

Illinois' defined benefit pension is calculated according to a fairly typical formula:

Annual benefit = (Final average salary) x (Years of creditable service) x (Service credit rate)

- **Final average salary** = The average of annual creditable earnings in the highest four consecutive years within the last 10 years of service.
- **Years of creditable service** = Years of prior service and membership service for which credit is allowed under Illinois law.
- **Service credit rate** = For all Tier II teachers and most Tier I teachers, the rate is 2.2 percent for service after June 1998. Tier I teachers with service prior to June 1998 receive a rate of 1.67 percent for each year from years one to 10 of service, 1.9 percent for years 11 to 20, 2.1 percent for years 21 to 30, and 2.3 percent for year 31 and beyond.

Recent Legislative Action

Illinois did not pass any pension reform legislation in 2011.⁷ A bill introduced in 2011 aimed at curbing recent high-profile abuses of the pension system was signed by Gov. Pat Quinn in early January 2012. A more dramatic reform proposal under consideration, Senate Bill 512, would make revisions to the tier system. It passed the Senate last March, but was resented to the House Rules Committee in December.⁸ In February 2012, Gov. Quinn released his own pension reform plan.⁹

Notes

1. Teachers' Retirement System of the State of Illinois, "Essential Facts About TRS," June 2011. Available online at: <http://trs.illinois.gov/subsections/general/pub13.pdf>.
2. "Essential Facts About TRS." Source for this section, unless otherwise noted.
3. Institute for Illinois' Fiscal Sustainability, "What Would it Mean to Shift More Illinois Teacher Pension Costs to School Districts?" March 2011. Available online at: <http://www.civicfed.org/iifs/blog/what-would-it-mean-shift-more-illinois-teacher-pension-costs-school-districts>.
4. "What Would it Mean to Shift More Illinois Teacher Pension Costs to School Districts?"
5. Teachers' Retirement System of the State of Illinois, "Tier I Member Glossary." Available online at: <http://trs.illinois.gov/subsections/members/glossary/v.htm>. "Tier II Member Glossary." Available online at: http://trs.illinois.gov/subsections/members/glossary/v_2.htm.
6. "Essential Facts About TRS."
7. Ronald K. Snell, "Pensions and Retirement Plan Enactments in 2011 State Legislatures," National Conference of State Legislatures, January 31, 2012.
8. "Illinois Governor Pledges Public Pension Reform in 2012," *Pensions & Investments*, February 1, 2012.
9. "Quinn Looks to Pension Reform for Savings," *The SouthtownStar*, February 12, 2012.

New Mexico

New Mexico is somewhat unique in its approach to public employee pensions. In 1998, voters approved a state constitutional amendment that provides that public employee pensions are considered vested property interests after five years, once minimum service requirements have been met. It is one of a handful of states that follows a property-based approach and the only state that does so through a specific constitutional provision.

Vested property interests are constitutionally protected against arbitrary government action and against being taken away without just compensation. There are no cases yet in New Mexico that interpret the exact scope of the legal protections granted to public employee pensions under the state's constitutional provision. However, relying on cases in New Mexico prior to the constitutional amendment, as well as cases outside the pension context, it seems likely that the constitutional provision will prevent the state from making any detrimental changes to pension benefits that have already been earned by participants who have satisfied the plan's minimum service requirements. It also seems clear that prior to a participant satisfying a plan's minimum service requirements, changes to that participant's benefits can be made freely. Finally, it is likely, though uncertain, that prospective changes to benefit accrual formulas can be made for all current employees.

The state constitution also provides, however, that nothing in the vested property rights provision shall be interpreted to prohibit modifications to retirement plans that enhance or preserve the plan's actuarial soundness. While this exception to the general rule has not been interpreted by courts, it suggests that any changes to public employee retirement plans will be permissible, provided they enhance or preserve the plan's actuarial soundness.

How Does New Mexico Law Protect Public Employee Pensions?

New Mexico is one of a handful of states that has included in its state constitution a specific provision addressing public employee pensions. Section 22 of Article XX of the New Mexico Constitution provides, "Upon meeting the minimum service requirements

Pension Protections in New Mexico

Type of protection: Property, by 1998 constitutional amendment; once minimum service requirements are met

Changes to benefits already earned: Likely cannot be reduced once minimum service requirements are met; changes may be permitted that enhance or preserve actuarial soundness

Changes to future benefit accrual: Uncertain, but likely that changes would be permitted

Changes to cost-of-living adjustments: Courts have not ruled; other states have come to mixed conclusions

of an applicable retirement plan created by law for employees of the state or any of its political subdivisions or institutions, a member of a plan shall acquire a vested property right with due process protections under the applicable provisions of the New Mexico and United States constitutions." It goes on to state, however, that "Nothing in this section shall be construed to prohibit modifications to retirement plans that enhance or preserve the actuarial soundness of an affected trust fund or individual retirement plan." These provisions were added to the New Mexico Constitution in 1998 following voter approval. There have been no cases in New Mexico interpreting these constitutional provisions. Instead, to determine their meaning and the scope of their protection, we must look to cases that address vested property rights in other contexts.

Labeling public employee pension rights as vested property rights is legally significant because property rights are entitled to the protection of due process under both the New Mexico and U.S. constitutions and cannot be taken away without compensation. These protections, however, need further explanation. First, due process has two separate components: procedural due process and substantive due process. Procedural due process requires that individuals whose property rights may be negatively impacted receive adequate notice of the change and an opportunity to respond. With respect to public employee pension rights, procedural due process rights would not offer significant protection against detrimental changes, as the standard legislative process would typically satisfy the notice and comment requirements. Substantive due process

considers whether a statute or government action “‘shocks the conscience’ or interferes with rights ‘implicit in the concept of ordered liberty.’” In considering substantive due process claims, courts determine the nature of the rights at issue in order to determine the proper level of scrutiny applicable to the state actions at issue. While no courts in New Mexico have ruled on the level of scrutiny to apply to public employee pension changes, courts in other states have found such changes to be subject to the “rational basis” standard, where changes are permitted if they are rationally related to a legitimate state interest. Provided, then, that the state is changing public employee pensions for legitimate state purposes (for example, to achieve a sustainable funding level) and not for illegitimate purposes (like raiding a pension fund or retaliating against public employees), substantive due process offers limited legal protection against changes.

If the reduction at issue is interpreted to be a change that “enhances or preserves” actuarial soundness, such changes would appear to be permissible for all employees.

The final source of potential protection is the constitutional requirement that property shall not be taken without just compensation. The New Mexico Supreme Court has stated that “any action by the Legislature that serves ‘to terminate, diminish or alter’ the value of pension benefits...must be compensated for by providing an equal or greater benefit.” This statement, however, is what is referred to as dicta—meaning that the statement did not directly relate to the holding or decision in the case but was made in passing. Statements such as these are in no way binding on future courts. As a result, it is not clear that the New Mexico Supreme Court, if it were to consider directly the issue of whether reductions in vested public employee pensions must be justly compensated as a taking of property, would adopt the

dicta quoted above as the relevant standard to decide the issue.

Even if New Mexico courts hold that the pensions of public employees who have met the applicable minimum service requirements cannot be diminished without just compensation, there is significant leeway given in the constitution by providing that nothing in the constitution shall be interpreted to prohibit changes that enhance or preserve the plan’s actuarial soundness. This caveat to the protections otherwise provided to public employee pensions has the potential to allow a very wide range of changes to participant benefits. After all, any reduction in benefits or increase in contributions would enhance a plan’s actuarial soundness, provided the plan is less than fully funded. If a court interprets that provision to be as broad as it appears to be, it could in fact open the door to a wide variety of benefit changes for public employees, regardless of whether minimum service requirements have been met.

Can Benefits That Have Already Been Earned Be Reduced?

Assume that a current state employee has accrued pension benefits for 10 years at a rate of 2.5 percent of salary per year and has satisfied the plan’s minimum service requirement. Could the state retroactively change the rate of accrual to be 2 percent of salary per year? While no cases in New Mexico have yet interpreted the scope of the constitutional protections for public employee pensions, it is highly likely that benefits that had already been earned could not be reduced once an employee has satisfied the plan’s minimum service requirements. If we change the example and assume the employee has not yet satisfied the plan’s minimum service requirements at the time of the change, the outcome would be different. Such an employee would not be entitled to any constitutional protection, and therefore the state may be able to retroactively change benefit accruals.

Of course, if the reduction at issue is interpreted to be a change that “enhances or preserves” actuarial soundness, such changes would appear to be permissible for all employees regardless of whether they have met minimum service requirements.

Can Benefits Be Changed for Future Years of Service?

Assume that a current state employee is accruing pension benefits at the rate of 2.5 percent of salary per year and has met the plan's minimum service requirements. Could the state change the rate of accrual, going forward, to be only 2 percent of salary per year? The legal answer is uncertain.

New Mexico's Constitution is not specific regarding the precise contours of what is protected as a vested property interest. It states that participants have a vested property interest once minimum service requirements have been met, but it does not define the vested property interest that is protected. In general usage, the term "vested property interest" is used to refer to something that you already possess. Given that the language is silent with respect to future accruals, that New Mexico courts have never held that future accruals are protected, and that the term is not typically used to refer to benefits to be earned in the future, it seems likely that prospective changes to benefit accrual rates would be permitted, even for employees that had satisfied minimum service requirements. Even if a court were to hold that a participant's vested property right includes the right to future accruals, as long as the change to future accruals preserves or enhances a plan's actuarial soundness, it would be permissible.

What About Cost-of-Living Adjustments?

New Mexico courts have never ruled on whether or to what extent cost-of-living adjustments (COLAs) that

apply to public employee pension benefits are legally protected. The extent to which COLAs are protected in New Mexico will depend on whether a court considers COLAs to be part of a participant's vested property interest, or rather a future benefit that is not vested until the time that it is granted. Other states have come to mixed conclusions regarding the nature of COLAs. In many states, pension benefits that are earned through services performed for the state are held to include any COLA that applies to such benefit. This approach is consistent with how federal law treats COLAs in the private employer pension context. If New Mexico were to adopt such an approach, once a participant had met the plan's minimum service requirements, the state would be required to pay the promised COLA on any pension benefit that had already been earned. However, it likely would be permissible to change the COLA formula going forward, as it applied to the pension earned by future years of service.

Some states, with the most recent example being Colorado, have found that COLAs are not part of a participant's accrued benefit. Rather, changes to COLAs are considered to be prospective changes as long as the change is made prior to the time the actual COLA is granted to a participant following retirement. And as long as a state otherwise allows prospective changes to pension benefits, this view of COLAs allows changes to be made freely prior to the time the COLA is actually awarded. It is uncertain which approach the New Mexico courts would adopt if they were to consider the issue. In addition, as with the other types of changes, if a change to COLAs preserves or enhances actuarial soundness, it may be permitted on that ground.

New Mexico's Teacher Pension System At-a-Glance

New Mexico's teachers receive pension benefits through the state's Educational Retirement Board (ERB). Most ERB members participate in the system's defined benefit plan, though some public university and community college employees can participate in the Alternative Retirement Plan, which is a defined contribution plan.

ERB Defined Benefit Program¹

Employee contribution: For employees who make less than \$20,000, 7.9 percent of the employee's salary; for employees who make more than \$20,000, 11.15 percent²

Employer (state) contribution: For employees who make less than \$20,000, 12.4 percent of the employee's salary; for employees who make more than \$20,000, 9.15 percent³

Vesting period: Five years

Retirement eligibility age: Varies, depending on when the teacher was hired

- A teacher hired before July 1, 2010, can retire when she has met one of three possible conditions: (1) her age and earned service credit add up to the sum of

75 or more, (2) she has reached the age of 65 or more with at least five years of earned service credit, or (3) she has earned service credit and allowed service credit totaling 25 or more years.

- A teacher hired on or after July 1, 2010, can retire when she has met one of the three following requirements: (1) her age and earned service credit add up to the sum of 80 or more, (2) she has reached the age of 67 or more with at least five years of earned service credit, or (3) she has earned service credit and allowed service credit totaling 30 or more years.

Cost-of-living adjustment: Depends on the change in the Consumer Price Index in the previous calendar year, with a maximum of 4 percent. If the CPI increases by less than 2 percent, the COLA equals the CPI change. If the CPI increases by more than 2 percent, the COLA equals half of the CPI change, though it cannot exceed 4 percent or fall below 2 percent. If the CPI decreases, benefits will not decrease. For the current fiscal year, the COLA is 1.6 percent.⁴

ERB Defined Benefit Formula⁵

New Mexico's defined benefit pension is calculated according to a fairly typical formula:

Annual benefit = (Final average salary) x (Years of service credit) x (Service credit rate)

- **Final average salary** = The higher of (1) average annual earnings for the last 20 calendar quarters (60 months) prior to retirement or (2) highest average annual earnings for any 20 consecutive calendar quarters.
- **Years of creditable service** = Years of both earned and allowed service credits. Earned service credits are those that employees receive for each calendar quarter they are employed and make contributions to the ERB Fund. Some employees can purchase allowed service credits—up to five or 10 years, depending on previous non-education service.
- **Service credit rate** = 2.35 percent

Recent Legislative Action

New Mexico passed two pension-related reform laws last year:

- **House Bill 628:** Makes a few temporary changes to contributions, including delaying contribution increases for employees.
- **House Bill 129:** Requires employees who return to work in ERB-covered jobs after retirement to pay the employee contribution to the pension system. Previously, the employer covered both employer and employee contributions to the pension for such workers.⁶

During the regular 2012 legislative session, which ended mid-February, two pension reform proposals were floated but did not pass. Gov. Susana Martinez's office has said she may call a special session to consider pension reform.⁷

Notes

1. New Mexico Educational Retirement Board, "Member Handbook," September 2011. Available online at: <http://www.nmerb.org/pdfs/ERBhandbooksept2011.pdf>. Source for this section, unless otherwise noted.
2. New Mexico Educational Retirement Board, "Schedule of Contribution Rates." Available online at: <http://www.nmerb.org/pdfs/contribrates.pdf>.
3. "Schedule of Contribution Rates."
4. New Mexico Educational Retirement Board, "Cost-of-Living Adjustment." Available online at: <http://www.nmerb.org/quicklinks/cola.htm>.
5. "Member Handbook."
6. Ronald K. Snell, "Pensions and Retirement Plan Enactments in 2011 State Legislatures," National Conference of State Legislatures, January 31, 2012.
7. "Unions Spar Over Public Pension Reforms," *The Santa Fe New Mexican*, February 9, 2012; "Legislative Scorecard: What Passed, What Failed," *The Santa Fe New Mexican*, February 17, 2012.

Ohio

Ohio courts initially held that public employee pensions were mere gratuities that could be modified by the state at any time. Beginning in the mid-20th century, however, Ohio courts have consistently held that once a participant has fulfilled all of the conditions necessary to receive a pension, that pension will be considered a contractual right and cannot thereafter be reduced or denied.

Under current Ohio law, changes can be made to a public employee's pension prior to the time the employee has fulfilled all of the conditions necessary to receive a pension. As currently interpreted, this would appear to allow not only prospective changes, but also changes to benefits that have already accrued for participants that have not yet satisfied all retirement eligibility conditions.

As a result, the state of Ohio has significant flexibility in changing retirement benefits for current public employees. Under current law, the benefits of participants not yet retired can be freely amended.

How Does Ohio Law Protect Public Employee Pensions?

Courts in Ohio have adopted a contractual approach to protecting public employee pensions. However, the contract between the state and employee exists only once the employee has been granted a retirement benefit. The result of providing that public employee pensions are contractual in nature only once the benefit has been granted means that detrimental changes can be made before the time that benefits are granted. If the state desires to make changes after benefits have been granted, they may do so only where the change is reasonable and necessary to serve an important public purpose under the state's police power. This is because under the Ohio and federal constitutions, a state may not, generally speaking, take actions that significantly impair a contract.

Prior to the time a participant is granted a retirement benefit, courts in Ohio have not found a contract or other legal form of protection to exist. As a result, while participants that have been granted retirement benefits enjoy very strong legal protection of such

Pension Protections in Ohio

Type of protection: Contract; once a participant has fulfilled necessary conditions to receive a pension

Changes to benefits already earned: Cannot be reduced or eliminated if retirement benefit granted

Changes to future benefit accrual: Yes

Changes to cost-of-living adjustments: Likely cannot be reduced or eliminated if retirement benefit granted

benefits, there appears to be no legal protection offered to participants pre-retirement.

Can Benefits That Have Already Been Earned Be Reduced?

Assume that an employee has been working for the state of Ohio for 10 years, and during that time the relevant retirement law provided for a pension benefit equal to 2.5 percent of salary per year of service. Could the Legislature change the law to reduce that rate of accrual to 2 percent of salary per year for the years the employee has already worked?

Under existing Ohio law, the answer would depend on whether the employee had already been granted a retirement benefit at the time such a change was enacted. According to the Ohio Supreme Court, a participant in a state retirement plan "vests" in her benefit only once that pension is actually granted. Prior to that time, the participant does not have a contractual right to the benefit. As a result, if the participant in our example had worked for 10 years but had not yet been granted a pension, it appears that retroactive changes could indeed be made. Once a participant has been granted a retirement benefit, however, it cannot be reduced or eliminated except where such a change could be justified under the state's police power.

Can Benefits Be Changed for Future Years of Service?

As in the example above, assume that a state employee has been accruing pension benefits at the rate of 2.5 percent of salary for 10 years. Could the state lower that rate to 2 percent on a prospective

basis, so that it applies only to years of service not yet performed?

The answer under existing Ohio law is clearly yes. Given that Ohio courts have held there is no contractual right to a benefit prior to the time the employee has satisfied all conditions necessary to receive a pension, changes that affect only future service are clearly permissible.

What About Cost-of-Living Adjustments?

Ohio courts have never directly ruled on whether cost-of-living adjustments (COLAs) could be modified

for public employee pensions. However, following the reasoning of the Ohio cases dealing with public pension modifications generally, it appears likely that any COLA provision in place at the time a participant is granted a retirement benefit cannot thereafter be reduced or eliminated, except as an exercise of the state's police power. For example, if a participant retired at a time when the law provided that all retirement benefits would be increased by 3 percent per year, it is likely that the court would view that COLA as part of a participant's vested retirement benefit that is entitled to contractual protection. However, COLAs could likely be changed for participants prior to the date they are granted a retirement benefit.

Ohio's Teacher Pension System At-a-Glance

In Ohio, teachers receive their pensions through the State Teachers Retirement System, or STRS Ohio. Through the system's defined benefit plan, STRS Ohio determines employee benefits in one of two ways: either using a traditional formula or a "money-purchase" calculation. More recently hired employees are also eligible to participate in a defined contribution plan or a "combined" plan, instead of the regular defined benefit plan.

STRS Ohio Defined Benefit Program¹

Employee contribution: 10 percent of annual gross earnings²

Employer contribution: 14 percent of annual gross earnings³

Vesting period: Five years⁴

Retirement eligibility age (for full benefits): At any age with 30 years of service, at age 55 with 25 years of service, or at age 60 with five years of service

Cost-of-living adjustment: 3 percent, not compounded

STRS Ohio Defined Benefit Formula⁵

Ohio calculates benefits using two different methods. Each retiree is eligible for whichever provides the greater benefit.

Method 1: Typical Benefit Calculation

Annual benefit = (Final average salary) x (Contributing service credit) x (Service credit rate)

- **Final average salary** = The average of the three highest years of earnings. This will increase to the five highest years in 2015.

- **Contributing service credit** = Years of service during which contributions were made to STRS Ohio or another Ohio public pension system, or for credits purchased for other types of service.
- **Service credit rate** = Varies depending on years of service.

For members with up to 34 years of contributing service credit: 2.2 percent for the first 30 years of contributing service credit and 2.5 percent for the 31st year. An additional 0.1 percent is added to the rate for each year above 31 (i.e., 2.6 percent for the 32nd year, 2.7 percent for the 33rd year, etc.) until 100 percent of final average salary is reached.

For members with 35 or more years of contributing service credit, 2.5 percent for the first 31 years of contributing service credit. An additional 0.1 percent is added to the rate for each year above 31 until 100 percent of final average salary is reached.

Method 2: Money-Purchase Benefit

A member's lifetime contributions plus interest are matched by employer funds to provide an annuity reserve. The annuity reserve is then divided by an annuity value, a factor which accounts for life expectancy and interest earned on the remaining reserve.

Other Retirement Options: Defined Contribution and Combined Plans⁶

STRS Ohio offers a defined contribution and a combined option to some members.

Who is eligible? Employees hired on or after July 1, 2001, may choose one of these two plans. In their fifth year of employment, they can decide to remain in their initially

selected plan or switch into the defined benefit plan, the defined contribution plan, or the combined plan.

How does the defined contribution plan work?

Employees contribute 10 percent of salary, and employers contribute 10.5 percent. STRS Ohio offers investment options that employees may select for their retirement accounts.

How does the combined plan work? As the name indicates, this plan combines aspects of the defined contribution and defined benefit plans. Employees contribute 10 percent of salary to a defined contribution account, and employers contribute 14 percent of salary to the defined benefit fund. The annual defined benefit payment to retirees is calculated using the same formula as the regular defined benefit plan, although the service credit rate differs: It is 1 percent for all years of service.

Legislative Action in 2011

In January 2011, the STRS Ohio Board approved a proposal to reform the pension system, including making

changes to eligibility, benefit formula, COLA, and member contributions. The plan, however, has yet to be approved by the Legislature and governor.⁷

Notes

1. State Teachers Retirement System of Ohio, “Understanding Your STRS Ohio Benefits—Plan Summary,” July 2011. Available online at: <https://www.strsoh.org/pdfs/brochures/20-101.pdf>.
2. State Teachers Retirement System of Ohio, “About STRS Ohio: Funding.” Available online at: <https://www.strsoh.org/about/4.html>.
3. “About STRS Ohio: Funding.”
4. Phone call to STRS Ohio, November 23, 2011.
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6. “Understanding Your STRS Ohio Benefits—Plan Summary.”
7. “Ohio Pension Reform in Limbo as Legislature Waits to Address Changes,” *Dayton Daily News*, August 7, 2011.

Appendix I: State Pension Protection Overview

State	Which Accruals Are Protected?	Legal Basis	Representative Case
Alaska	Past and future ¹	Contract, as defined in state constitution	Municipality of Anchorage v. Gallion, 944 P.2d 436 (Alaska 1997)
Arizona	Past; likely future as well, but untested	Contract, as defined in state constitution	None
Arkansas	Past	Contract, once participant is vested under plan terms	Jones v. Cheney, 489 S.W.2d 785 (Ark. 1973)
California	Past and future	Contract, upon commencement of employment	Betts v. Bd. of Admin., 21 Cal. 3d 859, 863 (1978)
Colorado	Unclear ²	Contract, at some time prior to eligibility for retirement	Police Pension & Relief Bd. of Denver, 366 P.2d 581 (Colo. 1961)
Connecticut	Unclear ³	Property	Pineman v. Oechslein, 488 A.2d 803 (Conn. 1983)
Hawaii	Past	Contract, as defined in state constitution	Kaho'ohanohano v. State, 162 P.3d 696 (Haw. 2007)
Illinois	Past and future	Contract, as defined in state constitution	Kraus v. Bd. of Trustees of Police Pension Fund of Niles, 390 N.E.2d 1281 (Ill. App. Ct. 1979)
Indiana	Unclear ⁴	Gratuity approach for involuntary plans; contract approach for voluntary plans	Bd. of Tr. of the Pub. Employees' Ret. Fund v. Hill, 472 N.E.2d 204 (Ind. 1985)
Kansas	Past and future	Contract, upon commencement of employment	Singer v. City of Topeka, 607 P.2d 467 (Kan. 1980)
Louisiana	Past	Contract, once vested, as defined in state constitution	Smith v. Bd. Of Tr. of La. State Employees' Ret. Sys., 851 So.2d 1100 (La. 2003)
Massachusetts	Past and future	Contract, upon commencement of employment	Opinion of the Justices, 303 N.E.2d 320, 327 (Mass. 1973)
Michigan	Past	Contract, as defined in state constitution	Ass'n of Prof'l & Technical Employees v. City of Detroit, 398 N.W.2d 436 (Mich. Ct. App. 1986)
Minnesota	Fact-specific	Promissory estoppel ⁵	Christensen v. Minneapolis Mun. Employees Ret. Bd., 331 N.W.2d 740, 747 (Minn. 1983)
Nebraska	Past and future	Contract, upon commencement of employment	Calabro v. City of Omaha, 531 N.W.2d 541 (Neb. 1995)
New Mexico	Past; unclear whether protection applies to future accruals	Property, once vested	None
New York	Past and future	Contract, as defined in state constitution	Birnbaum v. New York State Teachers' Ret. Sys., 152 N.E.2d 241 (N.Y. 1958)
North Carolina	Past	Contract, once vested	Faulkenberry v. Teachers' & State Employees' Ret. Sys. Of N.C., 483 S.E.2d 422 (N.C. 1997)
Oklahoma	Past; some informal indication that prospective changes would be permitted in some circumstances	Contract, once vested	Taylor v. State and Education Employees Group Insurance Program, 897 P.2d 275 (Okla. 1995)

State	Which Accruals Are Protected?	Legal Basis	Representative Case
Oregon	Past and future	Contract, upon commencement of employment	Oregon State Police Officers Ass'n v. State, 918 P.2d 765 (Or. 1996)
Texas	None ⁶	Gratuity	Kunin v. Feafanov, 69 F.3d 59 (5th Cir. 1995)
Vermont	Past and future	Contract, upon making mandatory contributions to the plan	Burlington Fire Fighters' Ass'n v. City of Burlington, 543 A.2d 686 (Vt. 1988)
Washington	Past and future	Contract, formed at the time of employment	Bakenhus v. City of Seattle, 296 P.2d 536 (Wash. 1956)
West Virginia	Past and future	Contract, prior to eligibility for retirement	Booth v. Sims, 456 S.E.2d 167 (W.Va.1994)

Source: Amy B. Monahan, "Public Pension Plan Reform: The Legal Framework," *Education Finance and Policy*, 5:4 (Fall, 2010), pp. 617-646. © 2010 by The American Education Finance Association, Inc. Reprinted with permission.

Notes

1. The reported cases in Alaska dealing with the protection of future accruals all pre-date Alaska's adoption of a defined contribution plan for state employees. However, based on the language in relevant decisions, it seems likely that Alaskan courts would also find the rate of future accruals to be protected in the defined contribution plan, which would prevent Alaska from reducing such rate for any current participants.
2. Cases have not addressed the distinction between past and future benefits to a sufficient degree to be able to summarize. Colorado courts have held that prior to eligibility to retire, plan changes can be made if the changes "strengthen or better" the retirement plan, or if they are actuarially necessary (Police Pension & Relief Bd. of Denver, 366 P.2d 581, 584-85 (Colo. 1961)). No cases have been found applying this standard to changes in future benefit accruals.
3. No Connecticut cases have dealt with changes to past and future rates of accrual. Presumably, state action to diminish past, vested accruals would be impermissible under the property approach, and changes to future accruals would be permitted provided the state action was not arbitrary or irrational. However, no Connecticut cases have directly addressed this issue.
4. In Indiana, benefits from involuntary plans are not protected until the participant retires. In voluntary plans, which are given contractual protection, it is unclear when the contract is formed and therefore whether future accruals are protected.
5. Minnesota is the only state that uses a promissory estoppel approach. Promissory estoppel is a legal principle providing that a promise that is otherwise not legally binding "may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment" (Black's Legal Dictionary, 8th ed. 2004). It is somewhat difficult to distinguish Minnesota's promissory estoppel approach from the more conventional contract approach. The Minnesota Supreme Court explains the distinction: "Promissory estoppel...focuses on the reasonableness of the employee's reliance to create a contractual obligation, while the contract clause assumes the existence of a contract and determines whether the state may alter its terms, based on the reasonableness of the state's actions when balanced against the employee's interests."
6. There is an exception for certain non-statewide public retirement systems. The accrued benefits in such systems are protected by a constitutional amendment (see Tex. Const. art. XVI, sec. 66).

Appendix II: Strengths and Weaknesses of Potential Pension Changes

Type of Fix	Potential Fix	Strength(s)	Weakness(es)
Technical	Raise Retirement Age	<ul style="list-style-type: none"> Politically symbolic Aligns teacher and non-teacher retirement age more closely 	<ul style="list-style-type: none"> Requires legal changes to affect current or retired workers Does not address portability issues
	Extend average salary years	<ul style="list-style-type: none"> Reduces likelihood of salary spikes Lowers average salaries in benefit calculation 	<ul style="list-style-type: none"> Requires legal changes to affect current or retired workers Does not address portability issues
	Change multiplier factor	<ul style="list-style-type: none"> Lowers benefit calculation 	<ul style="list-style-type: none"> Requires legal changes to affect current or retired workers Does not address portability issues
	Restrict sick leave days counted	<ul style="list-style-type: none"> Reduces likelihood of teachers saving leave time 	<ul style="list-style-type: none"> Requires legal changes to affect current or retired workers Does not address portability issues
	Lengthen vesting periods	<ul style="list-style-type: none"> Creates large financial incentives for teacher retention Rewards career teachers 	<ul style="list-style-type: none"> Requires legal changes to affect current or retired workers Makes portability issues worse
Political	Construct political safeguards, such as mandating minimum annual payments	<ul style="list-style-type: none"> Encourages long-term thinking Establishes safety net against quick decisions 	<ul style="list-style-type: none"> Reduces future legislative power Inflexible during market swings
Structural	Adopt defined contribution plan	<ul style="list-style-type: none"> More predictable budgeting Solves portability problems 	<ul style="list-style-type: none"> Requires legal changes to affect current or retired workers Individuals carry additional risks
	Adopt cash balance plan	<ul style="list-style-type: none"> More predictable budgeting Solves portability problems Easy to understand 	<ul style="list-style-type: none"> Requires legal changes to affect current or retired workers May produce lower investment returns

Source: Chad Aldeman and Andrew J. Rotherham, *Better Benefits: Reforming Teacher Pensions for a Changing Work Force* (Washington, DC: Education Sector, 2010).

Notes

1. See, Charley Shaw, "Minnesota Governor Tim Pawlenty signs pensions bill," *The Legal Ledger*, May 16, 2010; Pat Doyle, "Pension overhaul OK'd, but veto looms; DFL and GOP lawmakers supported the plan, but Pawlenty said it won't help the deficit," *Star Tribune*, May 13, 2010.
2. See, Chad Aldeman and Andrew J. Rotherham, *Better Benefits: Reforming Teacher Pensions for a Changing Work Force* (Washington, DC: Education Sector, 2010); See, Jennie Herriot-Hatfield, Amy Monahan, Sarah Rosenberg, and Bill Tucker, *Rhode Island Pension Reform: Implications and Opportunities for Education* (Washington, DC: Education Sector, 2011).
3. Ronald K. Snell, "Pensions and Retirement Plan Enactments in 2011 State Legislatures," National Conference of State Legislatures, January 31, 2012. Available online at: <http://www.ncsl.org/documents/employ/2011EnactmentsFinalReport.pdf>.
4. Mary Williams Walsh, "Two Rulings Find Cuts in Public Pensions Permissible," *New York Times*, June 30, 2011.
5. "Pensions and Retirement Plan Enactments in 2011 State Legislatures."
6. Robert M. Costrell and Michael Podgursky, "A Modest Proposal for Pension Reform" (Cambridge, MA: *Education Next*, Fall 2001). In follow-up correspondence, Costrell adds: "If she leaves before age 51, she has the choice of receiving a pension that is deferred for a number of years or cashing out her own contributions, but not the employer's. Until age 51, the present value of the pension that she can receive is less than the value of her contributions. The reason her pension is worth so little is that it must be deferred until she is eligible to start drawing it. Being vested does not mean she can start drawing the pension right away. If she starts work at age 25 and works 10 years, she is eligible to receive a pension, but she has to wait until she meets an age requirement, too. She has to wait until she is 67 for normal retirement (i.e., unreduced benefits) or to age 62 for early retirement (i.e., reduced benefits). The deferral of 1st draw means the present value of the pension is reduced. As a result, the best she can do prior to age 51 is cash out her contributions. She doesn't get the employer's contributions if she cashes out. That means no net pension wealth – i.e., nothing beyond what she put into it. (Indeed, she doesn't really even get the true value of her contributions, since Illinois doesn't pay interest.)"
7. The Rhode Island Retirement Security Act (2011-H 6319A as amended, 2011-S 1111 A as amended). Available online at: <http://www.rilin.state.ri.us/BillText11/HouseText11/H6319Aaa.pdf>.
8. Mary Williams Walsh, "Two Rulings Find Cuts in Public Pensions Permissible," *New York Times*, June 30, 2011.