A Special
Education Sector
Guide for Legislators

Five Things Education Supporters Should Know About Pension Reform

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As a state legislator, you're well aware of the fiscal pressures that have caused many states to change their pension systems. But you should also be aware of the impact that pension reform has on public education.

This brief guide shows you how and why pension programs affect your state's efforts to attract and retain the best teachers. It outlines five key areas you should consider as you evaluate proposed changes and ends with questions you need to ask about your state's pension system.

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It's the widening gap spooking statehouses across the country—the more than $1 trillion difference between what states have promised for public employee pensions and what they have actually set aside, according to the Pew Center on the States. In most states, these unfunded obligations exceed thousands of dollars for each resident.

These alarming statistics have led to an unprecedented effort to reform state pension plans. According to the National Conference of State Legislatures, 39 states have made significant changes to public pension plans in the last two years. And many more are under consideration.

Confronting this fiscal nightmare is the right thing to do. 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 roads to social services. But pension reform is not just a question of reversing the financial toll on a state. Action on pensions is urgently needed because this financial crisis is also an education crisis: the design of many state pension systems can actually prevent states from recruiting, retaining, and adequately compensating the high-quality teachers and principals that are critical to their educational and economic success.

Most pension systems are far from equitable: they highly reward some teachers, penalize others, and push some good teachers into premature retirement. They also allow teachers with similar years of experience to receive vastly different benefits. On top of these structural inequities, unchecked pension obligations threaten to siphon money that might otherwise go to higher wages for teachers, better professional development, and extended learning opportunities for students.

Right now, state lawmakers have an opportunity to solve the pension crisis in a way that also advances their states' ambitious and essential educational goals. It is crucial that they take this opportunity. As they do, they must consider five important issues:

1. Using Pensions to Promote Teacher Quality

Lawmakers are justly concerned that pension reform proposals could slash benefits for public employees. But it's not just the amount of the benefits that matters. Policymakers must also consider how the benefits are distributed.

How do most pension systems work?

Most public employee pension systems are *defined benefit* plans, in which the employer—in this case the state—provides the employee a certain regular payment during the entire length of his retirement years. Your state's standard formula, such as the one below, determines the amount of the pension benefit that a participant earns:

Annual benefit = (final average salary) x (years of creditable service) x (service credit rate)

This formula accounts for the salary an employee earned in his highest-earning years and the number of years he worked in that position. This figure is multiplied by something called a "service credit rate," essentially the amount of pension benefits that an employee earns each year.

Does the pension system treat all teachers fairly?

A major problem with the structure of most state plans is that they function much like a lottery, disproportionately rewarding some teachers over others. Although research shows that teachers' effectiveness increases quickly in their first few years, it shows little difference in effectiveness between a teacher with five years of experience and one with 30. Most pension systems do not reflect this fact. Often, benefits are heavily back-loaded toward the most veteran of teachers—those with 25 years or more of experience.

What happens when the system doesn't treat all teachers fairly?

This seniority-based retirement system combines with seniority-based compensation in salary and other benefits to create a situation in which the most senior teachers are compensated in ways that have little or no relation to their abilities or responsibilities. In other words, many pension systems reward certain ages and years of employment over others. And they give professionals moving to teaching from other fields little or no chance to catch up. Average pension benefit calculations often hide these disparities among different groups of teachers.

How do pension systems discriminate against different groups of teachers?

Teachers who stay in one district or state for their entire careers are generally well-served because their benefits are much greater than the contributions made on their behalf. But those who teach for less than 15 years or so, or who come from other careers or move in from another state, may receive far less than what is contributed on their behalf. This design is not only inequitable, it also distorts the decisions that teachers make about how long, where, and even whether to teach.

Can you give an example?

Before Rhode Island's recent pension reform, the longer a teacher worked, the higher the percentage of her income put toward a pension. Teachers in their 30th year earned a service credit rate of 2.5 percent, while those in their ninth year earned a rate of 1.6 percent. Some states don't even allow teachers to vest—to become entitled to a retirement benefit—until they have taught for 10 years. Other formulas even have two or three separate tiers, meaning that teachers with the same responsibilities earn different amounts based on when they joined the pension system and when they became eligible to retire.

How do discriminatory systems affect the quality of the workforce?

Along with pushing some teachers out too early, systems that favor a particular retirement age also force others to stay too long. In a nationwide survey by Education Sector in 2008, nearly four out of five teachers agreed with the statement that "too many veteran teachers who are burned-out stay because they do not want to walk away from the benefits and service time they have accrued." But about the same number indicated that making it easier to leave and return to teaching, without risking the loss of retirement benefits, would help school districts attract and retain high-quality teachers.

2. Aligning Benefits With Contributions

Over the long term, a pension system is sustainable only if the total contributions made by and for employees, along with investment gains, equal the benefits that employees receive. If these contributions and benefits are not aligned, the state will eventually confront a large deficit.

What are the advantages and drawbacks of a defined benefit system?

Although a defined benefit system, in which benefits are based on average salary and years of service, has many advantages, it also creates imbalances. On the one hand, it offers security to employees because the benefits remain the same or increase every year no matter how long a retiree lives. On the other, it presents risks to the state: policymakers are tempted to offer more benefits that are paid for with future dollars, but they usually don't provide assurances that funds will be there to meet future obligations.

What are the advantages and drawbacks of a defined contribution system?

One possible solution to the pension problem is a *defined contribution* plan, such as a 401(k), where the benefit varies and the contribution, from the employee and often matched by the employer, is fixed. There are significant advantages to these plans because they are portable and age-neutral: they let employees take their savings from one employer to another, and they don't create big incentives to retire at a set age or to work longer just to get benefits. The downside is that employees tend to save too little under 401(k) plans and, most important, they bear the entire investment risk. These plans often lead to less secure retirements; as the last five years demonstrate even prudent savers can see their retirement funds disappear in a down market. Just as states were tempted to increase benefits in more prosperous times, they must conscientiously avoid rash moves in the other direction.

Why is a hybrid plan a good solution?

Hybrid plans, which include *cash balance* plans, attempt to combine many of the advantages of defined contribution and defined benefit plans. Like a 401(k), a cash balance plan is portable and age-neutral. But like a defined benefit plan, it offers stable returns, thus providing greater retirement security. Cash balance plans also reap the financial advantages of group investing. With group investing, investment managers do not have to account for life-cycle considerations—older investors can't take the risks that young investors can—that can reduce returns. Most important, these plans honor the fundamental tenet of pension sustainability: they align contributions with benefits.

3. Sharing the Burden of Reform

Most pension crises are the fruit of many decades. So the responsibility for fixing pension systems should also be spread across many decades.

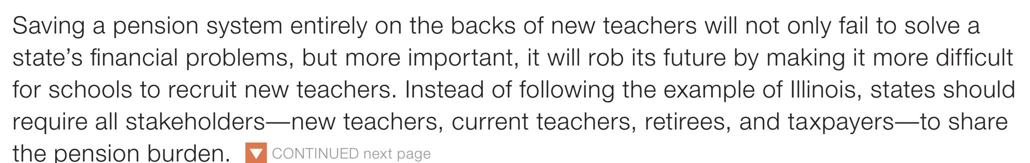
How have states tried to address pension shortfalls?

Some states have slashed the pensions of new teachers and used the contributions of these teachers to subsidize current teachers and retirees. In Illinois, for example, 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.

How will Illinois' reforms affect individual teachers?

Under recent Illinois reforms, new teachers, mobile teachers, 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*. If that same teacher decides to stop teaching in her 30s or 40s, she will not receive any employer contributions.

What's wrong with reducing the pensions of new teachers?



Saving a pension system entirely on the backs of new teachers will not only fail to solve a state's financial problems, but more important, it will rob its future by making it more difficult for schools to recruit new teachers. Instead of following the example of Illinois, states should require all stakeholders—new teachers, current teachers, retirees, and taxpayers—to share the pension burden. CONTINUED next page

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Should taxes be raised to fund pensions?

Increasing revenue should be an option. Taxpayers are often omitted in discussions of burden-sharing. Yet taxpayers, too, have a responsibility for their state's obligations.

4. Keeping Pension Reform Legal

Pension reform is not just an educational, financial, and political issue. It's also a legal issue. And a complicated one at that. State pensions are protected under laws that vary considerably from state to state. Legal protections for benefits already earned are one of the key reasons why many state pension reform efforts largely ignore retirees.

How has the legal approach to pensions changed over time?

Historically, public employee pensions were considered by the states to be mere "gratuities" —perks that could be amended or withdrawn at any time. However, in the early 20th century, many states began to reject this notion in favor of other legal approaches that granted more protection to pensions.

In what ways do states govern pensions today?

Only Indiana and Texas continue to follow the gratuity approach, and they do so in limited circumstances. Other states govern pensions under a variety of frameworks, ranging from explicit language in a state constitution to common law protections. States such as California protect the accrual of both past and future benefits from the first day of employment, while others such as Ohio protect only past accruals once a participant has vested, often years after first employed.

Are there ever any exceptions to pension laws?

Yes. An important exception comes through a state's "police power," or its authority as a sovereign to act to protect the health, safety, and welfare of its citizens. Even where the state is bound by a contract, as is often the case with promised benefits such as cost-of-living adjustments (COLAs) for current retirees, it always retains its police power.

How can a state invoke its police power to reform pensions?

Where a state seeks to rely on its police power to substantially impair a contract to which it is a party, the United States Supreme Court has held that a 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."

What must a state do to show that the change is necessary?

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
- The state could not have achieved its public policy goal without modification.

How have the courts ruled in cases involving police power?

There are 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. In a recent case in Minnesota, 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.

What was the court's rationale in the Minnesota case?

In upholding the COLA reduction, the court noted that all interested parties (current employees, retirees, the state, and taxpayers) were sharing in 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.

How does a state know when it can exercise its police power?

There is no objective test to determine whether a state may validly exercise its police power. Rather, it is always a fact-intensive, case-by-case inquiry.

5. Preventing Future Pension Shortfalls

In flush times, legislators and governors often increase pension benefits to public workers. But these elected officials are generally not around years later when the bill comes due. While state constitutions and court rulings offer many pension protections for workers, there are fewer safeguards to prevent states from making pension promises they can't keep.

What can be done to prevent states from taking on excessive obligations?

States can build safeguards into new pension laws. Georgia and Oklahoma, for instance, have passed constitutional amendments requiring legislators to pause between making a proposal to increase benefits and voting on that proposal. If the proposal seeks to change the benefit calculation, legislators must prepare a full report showing how they plan to pay for it.

What other measures can be taken?

Greater transparency is another tool to prevent not only shortfalls, but also inequitable retirement systems. Teachers deserve clear and accessible information about their pensions.

What kind of information should be reported?

Teachers need to know the amount they have contributed, what has been contributed on their behalf, and their expected retirement earnings. This type of information, familiar to 401(k) participants, is not necessarily available to participants in defined benefit plans.

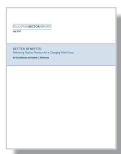
Is there anything else teachers, and the public, deserve to know?

If the state offers disproportionate benefits to a small group of teachers, the gap between contributions for individual teachers and their accrued pension wealth should be transparent to all.

Questions you need to ask about your state's pension system…

- Has your state pension's service credit rate been changed recently? How have the changes affected unfunded liabilities?
- Does your pension plan reward certain retirement ages or years of service over others? Why?
- Does your pension plan treat teachers in equal situations equally?
- How does your pension plan align contributions with benefits received?
- Are the proposed changes to your pension system fair to all teachers?
- How will the proposed changes affect teacher recruitment?
- Has there been an objective legal analysis of proposed reforms?

More From Education Sector on Pension Reform at http://bit.ly/TeacherPensionReform



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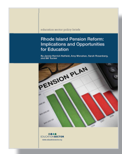

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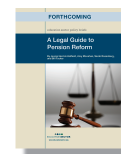

A Legal Guide to Pension Reform (Forthcoming 2012)

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- Are pension benefits structured to promote teacher quality?
- Are benefits aligned with contributions?
- Do reform proposals share the burden?
- Are the reform proposals legal?
- How can our state prevent future pension shortfalls?

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