

FUTURE SHOCK

Legislators stoking the coals on Kentucky's runaway pension train
a BLUEGRASS INSTITUTE REPORT by Lowell Reese



Future Shock: Legislators stoking the coals on Kentucky's runaway pension train
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THE ISSUE

The pension and healthcare funds for government employees in Kentucky – the state-administered pension systems – are in significant financial stress. The unfunded liabilities stand at \$31 billion.

WHY IT MATTERS

Public employee pensions in Kentucky are badly draining the budgets of city and county governments, dipping into the budget of the commonwealth as never before, pushing up the state’s debt level while pulling down its credit rating. The pension obligations are on the brink of dramatically crowding out funds for essential government services such as public safety and education.

Kentucky’s public servants and retirees are increasingly and rightfully concerned about the security of their retirement livelihood. But towering above that, funding their pensions has become a societal issue. The standard of living of all Kentuckians is at stake.

How is that, you ask? Human progress depends on economic progress, and economic progress depends on laws that favor it – and on education. Two-thirds of the state’s budget, the General Fund, goes to education. When public employee pensions compete with other government programs for funding, pensions will come first.

An education is not guaranteed in the U.S. Constitution; honoring a contract, arguably public employee pensions, is expressed in the U.S. Constitution, in Article I, Section 10, the contract clause.

Specific provision for government pensions is not included in the commonwealth’s constitution. However, protection language for public pensions is firmly embedded as “inviolable” contracts in Kentucky’s statutes and court rulings, language that legal experts say strengthens its judicial standing, if it’s ever contested in federal court.

So, the options are limited on how Kentucky can pull itself out of this deep hole, which it must do, ultimately, because the retirement benefits that were in place on the first day of a government worker’s job represent binding promises, guaranteed by taxpayers, that cannot be taken away, short of a court order, during the employee’s lifetime, or longer if the retiree predeceases his or her spouse.

Kentucky’s standard of living is at stake.

The state’s six retirement funds have long-term obligations (benefits owed to retirees) that are double the funds’ assets (the ability to pay the future obligations) – \$61.7 billion in future obligations but only \$30.7 billion in assets, which means that 50.3 percent of the obligations are *not* funded. That’s a collective figure; the state employees’ fund (KERS) is in the worst shape of all – in Kentucky and in the nation – with 67 percent of its future obligations *not* funded.

Lawmakers need to come up with \$23 billion for Kentucky’s retirement systems, on top of the systems’ current revenue stream, to get the systems in good health again. That amount would not entirely erase the \$31 billion unfunded liability, but an influx of \$23 billion would bring the funding up to an 80 percent level, where the actuaries and experts want it to be: 80 percent or above.

But finding \$23 billion for the pension systems in a state with only a \$9 billion annual budget has to be, obviously, a long-term project, which is acceptable, because pension obligations are amortized over 30 years.

But the pension systems must be funded; it's the law, and – like a co-signer on a bank note – the buck stops with the taxpayers.

Where to find the money? That is for legislators to decide. They created the problem by bestowing overly

generous retirement benefits on public employees, and they authored and allowed abuses for decades; and soon there will be no option but to make a painful adjustment – in fact, the Legislature is the only entity that can.

But where will they find a whopping \$23 billion? The most fruitful source – and by far the easiest politically – would be to help the systems' investment funds get a better return, a higher yield on their stocks, bonds and real estate.

Kentucky's State-Administered Public Employees Pension Systems
Unfunded Liabilities - All Six Plans 2000-2010

	Assets	Liability	Unfunded	% Funded	Payroll	Unfunded as % of Payroll
	(a)	(b)	(b-a)	(a/b)	(c)	[(b-a)/c]
2010 KERS	5,498,713,518	16,652,378,110	11,153,664,592	33	1,958,704,332	569.40%
CERS	9,282,130,042	15,964,217,577	6,682,087,535	58.1	2,703,404,040	247.20%
SPRS	425,752,375	1,047,405,301	621,652,926	40.6	51,506,712	1206.90%
Teachers	15,180,459,000	27,643,213,000	12,462,754,000	54.9	3,321,614,000	375.20%
Judges	237,127,031	336,353,140	99,226,109	70.5	29,886,624	332.00%
Legislators	64,140,292	82,208,573	18,068,281	78	4,916,770	367.50%
	30,688,322,258	61,725,775,701	31,037,453,443	49.7	8,070,032,478	384.60%
2009 KERS	6,132,921,824	16,331,419,054	10,198,497,230	37.6	1,900,456,488	536.60%
CERS	9,270,040,082	15,155,292,393	5,885,252,311	61.2	2,652,927,312	221.80%
SPRS	453,493,636	966,360,009	512,866,373	46.9	51,660,396	992.80%
Teachers	15,199,703,000	29,945,334,000	14,745,631,000	50.8	3,253,100,000	453.30%
Judges	255,609,584	330,676,362	75,066,778	77.3	29,886,624	251.20%
Legislators	67,342,542	78,644,456	11,302,914	85.6	4,916,770	229.90%
	31,379,110,668	62,807,726,274	31,428,616,606	50	7,892,947,590	398.20%
2008 KERS	6,712,284,627	16,720,857,311	10,008,572,684	40.1	1,986,583,548	503.80%
CERS	9,264,779,300	15,060,316,209	5,795,536,909	61.5	2,640,853,980	219.50%
SPRS	474,852,648	1,032,236,725	557,384,077	46	53,269,080	1046.40%
Teachers	15,584,858,000	28,979,065,000	13,394,207,000	53.8	3,190,300,000	419.80%
Judges	271,212,897	302,960,347	31,747,450	89.5	31,224,444	101.70%
Legislators	70,684,312	67,429,123	-3,255,189	104.8	4,755,214	-68.50%
	32,378,671,784	62,162,864,715	29,784,192,931	52.9	7,906,986,266	376.70%
2007 KERS	6,736,778,682	15,751,129,642	9,014,350,960	42.8	1,925,061,513	468.30%
CERS	8,580,325,853	13,848,608,386	5,268,282,533	62	2,535,847,284	207.80%
SPRS	464,022,420	980,718,515	516,696,095	47.3	49,247,580	1049.20%
Teachers	15,497,226,000	27,266,522,000	11,769,296,000	56.8	2,975,300,000	395.60%
Judges	272,238,056	279,495,588	7,257,532	97.4	31,941,180	22.70%
Legislators	69,823,247	64,649,950	-5,173,297	108	4,763,785	-108.60%
	31,620,414,258	58,191,124,081	26,570,709,823	54.3	7,522,161,342	353.20%
2006 KERS	6,646,254,598	17,940,200,780	11,293,946,182	37	1,840,978,097	613.50%
CERS	7,978,480,785	14,735,417,047	6,856,936,262	53.5	2,406,365,023	284.90%
SPRS	449,596,466	1,099,063,165	649,466,699	40.9	47,743,865	1360.30%
Teachers	14,989,200,000	24,666,600,000	9,677,400,000	60.8	2,859,500,000	338.40%
Judges	264,913,489	254,901,557	-10,011,932	103.9	26,976,964	-37.10%
Legislators	67,029,901	59,829,316	-7,200,585	112	4,426,035	-162.70%
	30,395,475,239	58,756,011,865	28,460,536,626	51.7	7,185,989,984	396.10%
2005 KERS	3,778,990,403	11,085,472,979	4,306,482,576	61.2	1,787,594,376	240.90%
CERS	7,534,684,120	11,252,827,771	3,718,143,651	67	2,296,396,728	161.90%
SPRS	453,718,704	692,753,086	239,034,382	65.5	43,720,092	546.70%
Teachers	14,746,100,000	23,898,700,000	9,152,600,000	61.7	2,703,400,000	338.60%
Judges	259,167,087	241,031,456	-18,135,631	107.5	28,483,104	-63.70%
Legislators	65,537,351	62,619,568	-2,917,783	104.7	3,545,131	-82.30%
	26,838,197,665	47,233,404,860	17,395,207,195	56.8	6,863,139,431	253.50%

	Assets	Liability	Unfunded	% Funded	Payroll	Unfunded as % of Payroll
	(a)	(b)	(b-a)	(a/b)	(c)	[(b-a)/c]
2004 KERS	7,167,472,346	10,112,600,135	2,945,127,789	70.9	1,772,077,308	166.20%
CERS	7,541,440,806	10,041,708,781	2,500,267,975	75.1	2,219,433,504	112.70%
SPRS	481,700,103	635,086,726	153,386,623	75.8	43,835,208	349.90%
Teachers	14,414,000,000	20,784,200,000	6,370,200,000	69.4	2,641,500,000	241.20%
Judges	247,388,763	218,117,389	-29,271,374	113.4	25,905,022	-113.00%
Legislators	62,786,767	50,213,770	-12,572,997	125	2,585,000	-486.40%
	29,914,788,785	41,841,926,801	11,927,138,016	71.2	6,705,336,042	177.90%
2003 KERS	7,442,589,136	9,253,730,977	1,811,141,841	80.4	1,787,693,652	101.30%
CERS	7,542,835,088	9,029,840,505	1,487,005,417	83.5	2,171,151,912	68.50%
SPRS	503,811,543	599,382,664	95,571,121	84.1	43,760,832	218.40%
Teachers	14,029,300,000	19,480,800,000	5,451,500,000	72	2,497,700,000	218.30%
Judges	254,306,434	202,838,112	-51,468,322	125.4	26,159,412	-196.70%
Legislators	63,909,258	49,168,446	-14,740,812	130	2,695,000	-547.00%
	29,836,751,459	38,615,760,704	8,779,009,245	77.3	6,529,160,808	134.50%
2002 KERS	7,687,593,535	8,492,666,859	805,073,324	90.5	1,721,085,383	46.80%
CERS	7,568,480,136	8,251,408,434	682,928,298	91.7	2,354,882,187	29.00%
SPRS	525,822,856	546,235,758	20,412,902	96.3	44,314,696	46.10%
Teachers	13,734,800,000	18,501,600,000	4,766,800,000	74.2	2,313,700,000	206.00%
Judges	265,693,347	185,310,835	-80,382,512	143.4	26,208,973	-306.70%
Legislators	67,892,070	51,095,992	-16,796,078	132.9	4,879,301	-344.20%
	29,850,281,944	36,028,317,878	6,178,035,934	82.9	6,465,070,540	95.60%
2001 KERS	7,775,423,509	7,713,262,975	-62,160,534	100.8	1,928,157,212	-3.20%
CERS	7,480,134,442	7,415,458,714	-64,675,728	100.9	2,178,373,904	-3.00%
SPRS	536,024,286	514,473,339	-21,550,947	104.2	44,646,678	-48.30%
Teachers	13,402,600,000	17,173,100,000	3,770,500,000	78	2,213,800,000	170.30%
Judges	280,506,852	172,720,874	-107,785,978	162.4	25,520,504	-422.40%
Legislators	70,853,489	47,068,104	-23,785,385	150.5	5,075,759	-468.60%
	29,545,542,578	33,036,084,006	3,490,541,428	89.4	6,395,574,057	54.60%
2000 KERS	7,644,661,413	6,752,834,300	-891,827,113	113.2	1,525,144,107	-58.50%
CERS	7,217,876,934	6,519,807,788	-698,069,146	110.7	2,029,209,988	-34.40%
SPRS	530,880,286	475,446,848	-55,433,438	111.7	43,619,383	-127.10%
Teachers	12,813,600,000	15,532,400,000	2,718,800,000	82.5	2,133,700,000	127.40%
Judges	271,044,593	179,117,938	-91,926,655	151.3	24,031,129	-382.50%
Legislators	66,971,719	45,253,158	-21,718,561	148	2,887,500	-752.20%
	28,545,034,945	29,504,860,032	959,825,087	96.7	5,758,592,107	16.70%

Getting the ARC up to 100 percent in steps by 2024 is a goal, but not a mandate, that the Legislature enacted in 2008. It will cost several billion dollars above today's level of ARC payments, which is only 48 percent of the ARC.

While the number of dollars needed to get to 100 percent won't be known until the actuaries make their assessments in future years, for purposes of illustration, *Kentucky Roll Call* estimates that the number could reach

\$5 billion, perhaps more, in additional ARC payments out of the general fund. That's new money that the General Assembly will have to find, and their sources are limited to four:

1. New revenue from an expanding economy
2. Borrow in the form of revenue bonds, shifting the debt
3. Take money from other government programs
4. Raise taxes, the most likely choice

Business pays nearly 43 percent of all taxes collected at the state level in Kentucky and slightly more than 49 percent of local government tax revenues. State and local tax combined, business pays about 45 percent of all taxes collected in Kentucky.

Both taxation and education are critical components of a business climate. It's as dependable as a schoolyard seesaw: if taxation goes up, private-sector jobs go down. And if pension expenditures crowd out money for education, Kentucky's ability to maintain the standard of living for its citizens could eventually be put at serious risk.

So, the pension problem has evolved into a business issue, because education and taxation are critical features of every state's business climate. Kentucky's massive unsustainable liability in its state-administered public employee retirement systems will, indeed, crowd out funds for education and lead to increased taxation, coming soon.

JUST HOW DEEP IS THE PENSION HOLE ?

Background: How we got to this point. As of June 30, 2010, the unfunded liability of Kentucky's public employee pensions was \$31 billion:

- Kentucky Teachers' Retirement System, \$12.5 billion
- Kentucky Employees Retirement System, \$11.2 billion
- County Employees Retirement System, \$6.7 billion
- State Policy Retirement System, \$621.6 million
- Judicial Retirement System, \$99.2 million
- Legislators' Retirement System, \$18.1 million

There are a variety of factors that impact the level of funding required to keep the retirement systems solvent:

- **Employer contributions:** The Kentucky General Assembly has paid less than the actuarial required contribution (ARC) to KERS every year since 2003.
- **Employee contributions:** Taken through payroll deductions each pay period.
- **Economic cycles:** Economic recessions drive return on investments below the assumed rate, which is 7.75 percent. This assumed rate of return is actually a rate guaranteed by the state, which forces taxpayers to assume all of the risk. If the stock/bond/real estate markets fail to deliver the assumed rate, taxpayers are on the hook for the shortage. Taxpayers are forced, by law, to guarantee the assumed rate of return. If pension funds fall 50 percent due to market fluctuations, it's no problem for pensioners. Taxpayers are legally bound to cover losses.
- **Retirements:** Number of employees who retire each year can be higher than expected, as occurred when early-retirement incentives were offered in the 1990s and early 2000s.

If the stock markets fail to deliver the assumed rate, taxpayers are on the hook for the shortage.

- **Healthcare costs:** Medical inflation beyond the amount estimated.
- **Cost-of-Living Adjustments (COLA):** Increases in retirees’ pensions, currently 1.5 percent annually, to offset the erosion of purchasing power by inflation.
- **Actuarial assumptions:** Changes in actuarial assumptions, such as increases in state payroll, which has been going up 4.5 percent a year [according to Sen. Damon Thayer, R-Georgetown, at a June 29, 2011 hearing of the Senate State and Local Government Committee].
- **Reporting methods:** Application of the Government Accounting Standards Board (GASB) Statement 43 requirements to the Kentucky plans. GASB 43 requires states to conform to one accounting standard for reporting the financial condition of pensions. Historically, there have been six different standards which allowed states to pick the accounting standard that made the fund look best. The move to GASB 43 is the result of bond rating agencies like Moody’s and Standard & Poor’s demanding more accurate financial disclosure.
- **Public policy:** Changes in state law dealing with pension and medical benefits for public employees.

RISING HEALTHCARE COSTS TAKING A TOLL

The rising price tag of healthcare insurance is the main cost driver for public employee pensions, especially for city and county governments. The pension-benefit sides of their ledgers are somewhat stable and predictable. It’s the medical side that gives city and county budget managers such a wild ride.

In 2003, the ARC rate for cities and counties was 6.34 percent of payroll for non-hazardous jobs and 16.28 percent of payroll for hazardous jobs. By 2010, the ARC had climbed to 16.16 percent of non-hazardous

payrolls and 32.9 percent of hazardous payrolls. Cavanaugh McDonald, the actuary for Kentucky’s city and county funds, says that by 2018, these rates could jump to 23.51 percent and an unbelievable 46.29 percent of non-hazardous and hazardous payrolls, respectively.

Health care costs affect all retirement programs, of course. But cities and counties have two special situations: (a) They have limited authority to raise taxes and are, therefore, more constrained than the General Assembly, which has unlimited authority – minus a few constitutional restrictions – to raise taxes; and (b) there’s a big wrinkle with school boards in cities and counties.

School boards (as employers) pay pension contributions into CERS each payday for “classified” personnel – custodians, cooks, bus drivers and so forth, who are typically employed nine months a year, not 12 months like everyone else in CERS; their incomes are around \$10,000 to \$12,000 a year.

A new pension system would save millions of dollars annually in the long run, but the teachers’ union won’t likely stand still for that, and therein looms a battle someday in the General Assembly.

Since the amount of money that employers pay into a pension fund is based on a percent of an employee’s salary. Some city and county officials claim that “classified” personnel, because of their low salaries, don’t pay their fair share into the retirement system. The claim is based on the fact that when these classified personnel retire, they still receive 100 percent healthcare coverage for life. In fact, many “classified” employees accept low salaries so they can get the health-coverage benefits when they retire. A similar argument is made by state employees for themselves – that their

salaries are not enough, but they stay on the job for the retirement benefits.

Consequently, cities claim they subsidize “classified” school employees, and in the past have petitioned the Legislature for a separation. Cities want their own retirement system, which the Legislature would have to authorize and create. A new pension system for cities and counties would save them millions of dollars annually in the long run, but the teachers’ union (KEA) won’t likely stand still for that, and therein probably looms a battle someday in the General Assembly.

RICH BENEFITS

Historically, Kentuckians took civil-service jobs with the understanding that the pay was less than private-sector jobs. In return for lower annual pay, they received more job security and a modest pension upon retirement.

That concept has been turned squarely on its head.

State employees in Kentucky receive generous compensation benefits (fringe and retirement). In fact, after Gov. Paul Patton signed an executive order in May 2001 authorizing unionization of state employees, David Jackson, president of the Coalition of State Employee Organizations – which opposed unionization because of its potential threat to the Merit System – characterized the salary-benefits package earned by state employees as “the best in the nation, second to none.” (The Kentucky Gazette, May 29, 2001.)

Advocates like the Kentucky Association of State Employees (KASE) have argued for years that the generous fringe and pension benefits are necessary for

the recruitment and retention of quality state employees on the basis that state government workers’ salaries are lower than those of private-sector employees.

While examining that issue in 2007, the Personnel Cabinet secretary conducted a survey of benefits for state government workers in Kentucky. In establishing the parameters of the survey, he did not include the political appointees at the top end or part-time employees at the bottom end. The survey included only employees covered by the state’s Merit System, and it found that they were paid on average \$18.87 an hour. That was higher than the average hourly earnings of Kentuckians in the private sector in all but three of Kentucky’s 120 counties. The three counties with higher average pay were all rural counties with a dominating business or industry.

Table 1: Comparisons of State Hourly Pay and Private-industry Hourly Pay (Source: Kentucky Personnel Cabinet, 2007, unpublished)

County	State Hourly Pay	Private Hourly Pay	Difference \$	Difference %
Hancock	\$ 18.87	\$ 21.70	\$ (2.83)	-15.0%
Ballard	\$ 18.87	\$ 19.88	\$ (1.01)	-5.4%
Boone	\$ 18.87	\$ 18.35	\$ 0.52	2.8%
Gallatin	\$ 18.87	\$ 18.23	\$ 0.64	3.4%
Fayette	\$ 18.87	\$ 17.75	\$ 1.12	5.9%
Bluegrass *	\$ 18.87	\$ 17.48	\$ 1.39	7.4%
Pike	\$ 18.87	\$ 16.75	\$ 2.12	11.2%
Jefferson **	\$ 18.87	\$ 16.49	\$ 2.38	12.6%
Woodford	\$ 18.87	\$ 15.98	\$ 2.89	15.3%
Oldham	\$ 18.87	\$ 15.35	\$ 3.52	18.7%
McCracken	\$ 18.87	\$ 15.33	\$ 3.54	18.8%
Warren	\$ 18.87	\$ 15.15	\$ 3.72	19.7%
Hardin	\$ 18.87	\$ 15.10	\$ 3.77	20.0%
Daviess	\$ 18.87	\$ 14.85	\$ 4.02	21.3%
Anderson	\$ 18.87	\$ 14.42	\$ 4.45	23.6%
Mason	\$ 18.87	\$ 14.00	\$ 4.87	25.8%
Owen	\$ 18.87	\$ 13.30	\$ 5.57	29.5%
Calloway	\$ 18.87	\$ 12.98	\$ 5.89	31.2%
Pulaski	\$ 18.87	\$ 12.78	\$ 6.09	32.3%
Johnson	\$ 18.87	\$ 12.38	\$ 6.49	34.4%
Breckinridge	\$ 18.87	\$ 12.33	\$ 6.54	34.7%
Grayson	\$ 18.87	\$ 12.00	\$ 6.87	36.4%
Hart	\$ 18.87	\$ 11.60	\$ 7.27	38.5%
Green	\$ 18.87	\$ 10.47	\$ 8.40	44.5%

* Bluegrass: Bourbon, Clark, Fayette, Franklin, Jessamine, Madison, Scott, Woodford.

** Jefferson: Jefferson, Oldham, Shelby, Spencer, Bullitt.

Of course, some industries pay higher hourly earnings than state government while some state employees may be underpaid. But on average, state employees receive higher hourly pay than the rest of Kentucky’s workforce – and their fringe benefits seem much better than pensions in the private sector. Data to make an

On average, state employees receive higher hourly pay than the rest of Kentucky’s workforce – and their fringe benefits seem much better than pensions in the private sector.

absolute comparison is unavailable because private-sector pension plans are proprietary and employers don’t want to release that information to government or to competitors.

Nonetheless, the Personnel Cabinet secretary called five major

Around 4,000 people apply for state jobs each month.

Kentucky employers in the private sector. Although their human resource managers were reluctant to provide specifics, four of the five said

the state’s plan is richer; only one, a national automobile manufacture notorious for providing lucrative pensions, had a richer plan.

Nationwide, public employee retirement benefits are 60 percent higher than in the private sector, according to the Employee Benefits Research Institute.

The work hours, pay, pension and health-insurance benefits – all of which seem to be better than the private sector – make it easier to explain the high demand for government jobs – especially in rural areas of Kentucky. Government is the largest employer in about half of Kentucky’s 120 counties. Chapter 18A, the section of Kentucky law governing state employee compensation and healthcare benefits, gives a

preference to workers already in the system for internal job promotions and transfers. Therefore, many people are willing to take a job even at a low entry level, for they know that within five to 10 years they can be in a high-paying job. Around 4,000 people apply for state jobs each month. Once they get in the system, it’s extremely hard to get fired.

BENEFIT CREEP

The natural tendency of legislators, perpetually with an eye toward the next election, is to reward government employees – particularly those who live and vote in their districts – with increased pension benefits. This usually happens gradually in silent, cat-like steps, with each step gradually increasing the debt burden on taxpayers, the ultimate guarantor of payment.

All pension benefits are the absolute prerogative of the General Assembly. When lawmakers amend pension laws, chances are they will use some obscure way to inflate benefits without the general public realizing it. The retirement systems have at least 41 moving parts that can be wiggled, increasing benefits. It’s how benefit creep happens.

FRINGE BENEFITS

1. It’s difficult to fire a career employee from a state job. Job security is nearly guaranteed by a law enacted in the 1960s called the Merit System. As of June 27, 2007, the state had 30,361 people in the Merit System. And during the 12-month period (July 1, 2007 to June 30, 2008) only 112 were fired, of which one was reinstated on appeal, while hiring 2,991 new Merit System employees.
2. State employees work 3.25 weeks less during the year than the rest of Kentucky’s workforce. Typically, state employees work 37.5 hours a week.

3. They have more days off – holidays, sick leave, vacation, voting and donating blood – than the rest of Kentucky’s workforce:
 - (a) **State employees get 11.5 holidays a year (12.5 days in presidential election years).** State government’s holidays are: Martin Luther King Jr. Day, Good Friday, Memorial Day, Independence Day, Labor Day, Veterans Day, Thanksgiving (2 days), Christmas (2 days) and New Year’s (2 days).
 - (b) **State employees can accumulate up to 240 hours (6.4 weeks) of “comp time,” which they can add to their end-of-career compensation to enrich the formula for lifetime pension payouts.** An estimated 80 percent of state employees are carrying a balance of 150 to 240 hours of “comp time.” For employees in non-policy positions, comp time is required to be paid within two weeks of retirement.
 - (c) **State employees can accumulate unlimited hours of sick leave.** Like comp time, sick leave applies toward retirement when calculating the payout, i.e., it can be applied to the last 12 months. An employee with 30 years of service can accumulate more than two years of sick leave. They can’t cash it out, but may apply it to years of service. It’s possible for the employee to retire with full retirement benefits after 25 years, instead of 27. It’s based on 1 sick day per month for the first 10 years, 1.5 days per month for the second 10 years, and 2 days per month for 20 years of service and beyond.
 - (d) **State employees can carry forward a maximum of 60 vacation days (roughly one-fourth of a year), which, like comp time and sick days, can be applied to the formula for calculating lifetime pension benefits.** Vacation days are awarded as follows: During the first five years of service, the employees gets 12 days; between 5-10 years of service, 15 days; 10-15 years of service, 18 days; 15-20 years of service, 21 days; Over 20 years of service, 24 days. Vacation days can be carried forward to a maximum of 60 days (12 weeks).
 - (e) **State employees get four hours off to vote during each primary and general election (one full day each election year).**
 - (f) **State employees can take off four hours each quarter (two days a year) to donate blood.**
4. Retirement age. Employees in non-hazardous duty jobs, hired before Sept. 1, 2008, may retire with 27 years of service, regardless of age, and receive unreduced retirement benefit for life. Employees in hazardous duty jobs may retire with 20 years of service regardless of age and receive unreduced retirement benefits for life.
5. State employees pay lower premiums for health insurance, and the percent they pay hasn’t changed in 11 years – even though the cost of health insurance has risen dramatically during that time. Kentucky’s taxpayers have picked up 100 percent of the increased tab for 11 straight years.
6. The average hourly earnings of state (Merit System) employees are higher than the rest of Kentucky’s workforce. See Table 1.

**UNTOUCHABLE GUARANTEE:
TAXPAYERS ON THE HOOK**

In addition, state employees’ pension payouts are guaranteed – untouchable by ups and downs in the economy, because their pensions are part of a “defined benefits” plan, and the promised benefits are fortified as an “inviolable contract.”

DEFINED BENEFIT

This means the employee’s retirement payout is calculated by a three-factor formula that has no relationship to return on investments in the marketplace. Nationwide, 90 percent of state and local government workers have a defined-benefit pension with a guaranteed payout, but only 24 percent of workers in the private sector have such plans.

INVIOLENT CONTRACT

State and local governments are bound by what is called an “inviolable contract” with their employees in regard to the retirement systems. There’s no escape or forgiveness on promised pension benefits, short of a court ruling. A court in Oregon recently undid part of that state’s inviolable contract. But it’s commonly believed Kentucky’s inviolable contract language is among the strongest and most clearly delineated in the nation.

It’s not a constitutional provision in Kentucky; however, it’s in contractual law. Several Attorney General opinions, and at least one Kentucky Supreme Court case (*Jones v. KRS Board of Trustees*) have upheld the Kentucky statutes.

As a result, retirement benefits in place on the day the employee is hired that fall under the expressed language of being protected by an inviolable contract cannot be reduced during the employee’s lifetime, except for cost-of-living adjustments (COLAs) and health insurance in the teachers’ retirement system.

Public employee pension plans in all 50 states contain inviolable contract language. However, the PEW Foundation reports that only nine states – Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, New Mexico, New York and Texas – have an inviolable-contract requirement for public employee pensions included in their state constitutions.

State employees’ pension payouts are guaranteed – untouchable by ups and downs in the economy.

CULTURE OF SECRECY

State government operates a total of six different retirement systems for the commonwealth’s public employees. Each of the retirement systems has two funds – a “pension fund” and a “health insurance fund.”

All of the retirement plans are creations of the Kentucky General Assembly, which establishes and controls each plan’s governing rules in accordance with federal pension laws. Every pension plan administrator must work within the parameters set forth by the Legislature.

Every aspect of Kentucky’s public pension plans – from their richness to what information is concealed from the public – is the sole prerogative of the General Assembly. Salaries of state and local government employees are readily available online. However, once those workers retire, information about their pensions – predominantly funded by taxpayers – is hidden from the public. A well-run, transparent government would make this information available and easy to find.

Kentucky's state-administered public employee retirement systems

This is the retirement system for the executive branch of state government. It was established by the Legislature in 1956 under Gov. A.B. “Happy” Chandler. The governing authority is in Chapter 61 of the Kentucky Revised Statutes.

The Kentucky Employees Retirement System (KERS)

This system serves the vast majority of state employees, including all state workers except state police officers, judges and legislators. The following government entities typically participate in KERS, according to a June 2011 report by the Office of the State Auditor. The number of agencies participating for each agency is noted in parentheses:

- State agencies (169);
- Other agencies like universities, mental health boards and health departments (144);
- Special districts and boards (4)
- Child support offices (county attorneys) (60);
- Other state-administered retirement systems (3).

KERS is under the umbrella of the Kentucky Retirement Systems (KRS), which administers three retirement systems, all of which are qualified defined benefit plans. Each of the three systems – KERS, CERS and SPRS – serves active members (those currently employed and actively contributing to their plans), inactive members (former employees who are not actively contributing to their plans and are not receiving benefits) and retired members (former employees who are receiving benefits).

In fiscal year 2010, KRS had total administrative expenses of more than \$34.5 million. Even though

these funds are included in the budget of the commonwealth, no General Funds dollars are appropriated for administration. Instead, those costs come from KRS's trust funds, the funds for investment earnings and contributions made by employees and employers.

As of June 30, 2010, KRS served a combined total of 318,981 active, inactive and retired members through the three systems, as follows:

KERS – 123,138, of which 59,195 were active

CERS – 193,690, of which 96,298 were active and

SPRS – 2,153, of which 961 were active.

The County Employees Retirement System (CERS)

Established by the Legislature in 1958 under Gov. A.B. “Happy” Chandler, this system serves

employees of city and county governments, including special districts. The governing authority is in Chapter 78 of the Kentucky Revised Statutes. Its funding comes from the budgets of local governments (plus

employee contributions and return on investments), not from the General Assembly. It includes all local government employees, except Fayette County policemen and firefighters, who have their own separate retirement system. The following government entities typically participate in CERS, according to a June 2011 report by the Office of the State Auditor.

County Employee Retirement System funding comes from the budgets of local governments, not from the General Assembly.

The number of agencies participating for each agency is noted in parentheses:

- Area Development Districts (13)
- Boards of Education (174)
- Cities (218)
- County Attorneys (67)
- County Clerks (15)
- County Government Agencies (260)
- Fire Departments (71)
- Hospitals (3)
- Jailers (9)
- Libraries (83)
- Planning Commissions (11)
- Police Departments (91)
- Police and Fire Departments (combined) (61)
- Sanitation Departments (53)
- Sheriff Departments (53)
- Special Districts and Boards (161)
- Utility Boards (104)
- Urban County Government Agencies (4)

**State Police Retirement Systems
(SPRS)**

This is the retirement system for uniformed Kentucky State Police officers. It was established by the Legislature in 1958 under Gov. A.B. “Happy” Chandler. The governing authority is in Chapter 16 of the Kentucky Revised Statutes.

**Kentucky Teachers Retirement System
(KTRS)**

This is the retirement system for local school districts and other educational agencies in the state, including university faculty and four-year-degree administrators. It was established in 1938 under Gov. A.B. “Happy” Chandler during his first term as governor (1935-1939), and funded in 1940. The governing

authority is in Chapter 161 of the Kentucky Revised Statutes.

**Kentucky Judicial Form Retirement System
(KJFRS)**

This is the retirement system exclusively for members of the bench established by the Legislature in 1960 under Gov. Bert T. Combs. The governing authority is in Chapter 21 of the Kentucky Revised Statutes.

**Kentucky Legislators Retirement Plan
(KLRP)**

This is the retirement system for legislators – the publicly elected part-time members of the Kentucky General Assembly. It was established in 1980, during the administration of Gov. John Y. Brown Jr. The governing authority is in Chapter 6 of the Kentucky Revised Statutes.

Six systems, 16 funds. Each of the six retirement systems has two funds – a “pension fund” and a “health insurance fund.” Further, the KERS and CERS have “hazardous” and “non-hazardous” categories of employees, and there are separate funds for each, which are segregated “pension” and “health insurance” funds. The total number of funds in the state-run retirement systems is 16.

All of the media hoopla in recent years about the public pension systems teetering on the brink of bankruptcy has not included the pension and health plans for legislators and judges. These two systems are relatively small and adequately funded, although in 2010, both systems had a modest unfunded liability. Still, it probably will come as no surprise to many that the legislators’ plan offers the richest benefits and is

the most adequately funded of the state’s six pension plans.

GOVERNING BOARD

A nine-member Board of Trustees governs the KRS, the administrative arm for KERS, CERS and SPRS members. The trustees are elected by the beneficiaries, appointed by the governor or serve ex officio as follows:

- Two trustees are elected by KERS members
- Two trustees are elected by CERS members
- One trustee is elected by SPRS members
- Three trustees are appointed by the governor
- The secretary of the Personnel Cabinet serves ex officio (non-voting member)

KRS Board Trustees serve a term of four years. After passage of House Bill 1 during the 2008 Special Session of the General Assembly, elected trustees can serve no more than three consecutive four-year terms.

The plans for judges and legislators are managed by the same staff, but each plan has its separate funds and separate boards of directors.

The teachers’ retirement system, unlike the others, stands alone as a single entity with its own administrative staff and board.

FUNDING AND PAYOUTS

There are three sources of funds for each of the plans: employee contributions, employer

contributions and investment income. The employees’ payroll contributions comprise, on average, about 16 percent of a fund’s total revenue; the employers’ payroll contribution makes up about 20 percent; and investment earnings account for remaining 64 percent. These percentages are based on historical data and are consistent with national figures.

Actuaries determine each year how much money is needed to keep the systems financially secure. That amount is called an Actuarially Required Contribution (ARC), and it’s expressed in terms of percent of payroll. The ARC percentage is the factor used to calculate how much money the Legislature should appropriate each year to the pension funds of KERS (both non-hazardous and hazardous) and the State Police system.

In recent years (11 of the last 15), the Legislature has not fully appropriated its ARC, which has resulted in, among other factors, an increase of the unfunded liability.

In recent years (13 of the last 18), the Legislature has not fully appropriated its ARC, which has resulted in, among other factors, an increase of the unfunded liability. House Bill 1, enacted in June 2008, established a schedule for the Legislature to gradually pay a higher percentage of the ARC each year until it reaches 100 percent for KERS non-hazardous in 2024, KERS hazardous in 2018, and the State Police by 2019.

The first increase in the percent – and the search for new money to pay for it – began in the 2010 session of the Legislature, in the state’s 2011-12 biennial budget. The Legislature committed itself to pay 44 percent of its ARC rate in the FY 2011 budget and 48 percent in the FY 2012 budget.

Pension payouts are distributed according to a formula contained within a “defined benefits” plan. This policy guarantees public employees an actuarial lump sum (except in KTRS) at retirement or lifetime payments based upon a three-factor formula: The number of years of service, average salary and the service credit percent (for example, 27 years x \$36,000 x 2.0%).

Members of the General Assembly, past and present, deserve more of the blame than any other factor for Kentucky not having enough assets on hand to cover retirement commitments they have made to public employees.

Defined benefit plans, as established under Section 401(a) of the Internal Revenue Code, highly favor the employee (retiree) over the employer (taxpayers). They are used by most states and in 90 percent of the nation’s public pensions. The employee pays into the system a fixed amount (in Kentucky, in the KERS, for example, 5 percent of salary for non-hazardous duty jobs and 8 percent for hazardous duty jobs). In return, the employee receives guaranteed lifetime retirement benefits regardless of the financial health of the pension fund. It’s a fortified guarantee. The state cannot escape making the payments in full, no matter what crisis the fund may be experiencing, because the pension is an “inviolable contract.”

The “defined benefit (DB)” approach is a major point of contention in the Legislature. Senate President David Williams has attempted unsuccessfully to add a “defined contribution (DC)” approach, so that state employees would have combined DB and DC pension plans. For example, of the five pennies per dollar that now come out of a state employee’s paycheck and goes into the DB plan, two of those pennies could go, instead, to a DC plan, which, over

time, would lower the systems’ unfunded liability by estimated 40 percent.

Under a “defined contribution” plan, pension benefits would be paid to the retiree based on the level of his or her contributions plus the employer contributions and earnings on those contributions in the marketplace. It would be a model of a 401(k)-style plan now common in the private sector. Alaska and Michigan have strictly defined contribution plans; some other states have a combination. Private industry has rapidly moved in this direction during the past 15 to 20 years, and it’s catching on in governments in some states.

WHY A DEFINED CONTRIBUTION PENSION PLAN IS BETTER FOR TAXPAYERS

Private-sector companies commonly measure employment costs, which include recruiting employees, salaries and benefits, termination costs and pensions. If a *defined benefit* retirement plan is in place, healthcare and pension payments continue until the retired employee and his beneficiaries are deceased. In a *defined contribution* retirement plan, the costs of the pensions end when employment does.

To illustrate why a *defined contribution* plan would be better for taxpayers, the following contrasting examples are provided. In both examples, the employee was hired into a KERS non-hazardous position after Sept. 1, 2008, the effective date of a law enacted in June 2008 requiring that new hires must be 57 years old to retire with full benefits and must meet the “Rule of 87,” which means the age and years

of service must add up to at least 87. The employee may retire earlier and not meet the 87 Rule, but benefits would be reduced. An employee in a KERS non-hazardous position hired before Sept. 1, 2008, can retire with full benefits at any age after 27 years of service.

Example 1: A state employee in a *defined benefit* pension plan is hired at age 22, works 33 years, and then retires at 55 years-of-age. The employee, a male, is expected to live to be 80 (life expectancy table), drawing pension and health benefits for 25 years. Let's assume his average annual salary was \$42,000 and his "final average salary" (average of highest five years) was \$56,000. The employee's pension allowance, based on the "defined benefit" formula (\$56,000 high-five salary x 33 years of service x 2 percent multiplier) would be \$36,960 a year, plus healthcare coverage. Therefore, the annual pension turns out to be 66 percent of the employee's final "high-5" salary.

Let's say that the healthcare coverage, the share of the insurance premium paid by the state during his employment, averaged \$5,954 per year*, and he is statutorily guaranteed healthcare coverage during retirement, which averaged \$2,265 a year (with the Medicare offset^).

The cost of employment and retirement (under defined benefit plan)

Category	Cost of Employment	Cost of Retirement
Salary / Pension	\$42,000 x 33 years = \$1,386,000	\$36,960 x 25 years = \$924,000
Healthcare	\$5,954 x 33 years = \$196,482	\$2,265 x 25 years = \$56,625
Sub-totals	\$1,582,482	\$980,625

In the above chart, the cost of employment and retirement combined is \$2,563,107 — that's before adding the 44.91 percent ARC, which adds an additional \$102,164 to the cost (see footnote #1). The **GRAND TOTAL** in Example 1 is = **\$2,665,271**

Example 2: A state employee in a *defined contribution* plan, 401(k) style, is hired at age 22, works 33 years, and then retires at 55 years-of-age, with an average salary of \$42,000 per year. This example applies the contribution rates projected by the Kentucky Retirement Systems' actuary for the *defined contribution* plan proposed in Senate Bill 2 during the 2011 legislative session, in which the state would match the employee's pension contributions in a 401(k)-style plan, up to 5 percent. The state continues making its ARC payment, which has three components: (1) the "normal employer contribution," (2) the "unfunded actuarial liability," and (3) an appropriation for the "defined contribution" plan. The *defined benefit* and *defined contribution* plans run simultaneously until the obligations in the *defined benefit* plan wash through.

The state's appropriations from the General Fund to the employee's retirement plan – for pension and health insurance – was 44.91 percent of the employee's salary, of which 34.15 percent was for the pension and 10.76 percent was for the insurance. These are averages of the rates projected by the Kentucky Retirement Systems' actuary^^ for a 25-year retirement from 2011 to 2035. For both pension and insurance, the budget appropriation has two components: (1) the "normal employer contribution," and (2) the "unfunded actuarial liability," both of which are paid into the retirement system while the public employee is still an active worker. This is commonly known as the ARC, or "actuarial required contribution," and the percent factors are anticipated actual payments based on HB 1 in 2008, which set a goal to gradually increase the funding level to 100 percent by 2024 for the KERS.

* Kentucky Personnel Cabinet website, "2012 Monthly Premiums and Contributions Non-Smoker Rates"

^ At age 65, the employee's health insurance premium is off-set my Medicare, which reduces the state's cost by appropriately 80 percent.

^^ Letter to Chief Operations Officer of the Kentucky Retirement Systems from Thomas J. Cavanaugh FSA, FCA, MAAA, EA, Chief Executive Officer [of Cavanaugh McDonald Consulting LLC], "Subject: Actuarial Analysis of Senate Bill 2GA," February 25, 2011-Revision.

Note 1: The \$102,164 in additional cost in Example 1 is the estimated amount of the normal costs and unfunded liability portions of the 34.15 percent pension contribution rate appropriated by the General Assembly but not reflected as an expense in the retirement section of the chart.

The state’s assumed appropriations from the General Fund to the employee’s retirement plan – for the pension and health insurance – is 42.61 percent of the employee’s pay, of which 31.84 percent is for the pension and 10.77 percent is for the insurance. These are averages of the rates projected by the Kentucky Retirement Systems’ actuary for a 25-year retirement from 2011 to 2035.

The cost of employment and retirement (under defined contribution plan)

Category	Cost to State for Employment	Cost to State for Retirement
Salary and Pension	\$42,000 x 33 years = \$1,386,000	Employer Contribution ^{^^} = \$334,286
Healthcare	\$5,954 x 33 years = \$196,482	\$2,265 x 25 years = \$56,625
Sub-total	\$1,582,482	\$390,911

In the above chart, the cost of employment and retirement combined is \$1,973,393 — that’s before adding the extra ARC health insurance assessment, which is approximately an additional \$56,447. The GRAND TOTAL cost for employment and retirement in Example 2 is = \$2,029,840

While these examples are for illustration purposes only, they do show that a *defined contribution* plan would save the state approximately \$635,431 – on just one “mid-management” career employee. That savings is realized primarily because in a 401(k)-style plan the employee’s pension is no longer a state obligation. In Kentucky’s *defined benefit* plan, investment earnings cover about 65 percent of the employee’s pension allowance, and that expense in time essentially would be erased.

But switching Kentucky to a *defined contribution* plan would in the early years be hugely expensive. The first 15 years would cost the state (just the KERS non-hazardous alone) \$5.6 billion, according to the actuary. However, beginning with the 16th year, savings would kick in. Between the years 2028 and 2035, in the KERS alone the retirement system would save \$11.3

billion – and presumably after 2035 additional billions each year.

WHY ARE WE \$31 BILLION IN THE RED?

In the pension ecology, as in Nature, all things are related. Benefits promised to retirees depend on employee and employer contributions and on investment returns; contributions and investment yields depend on policy decisions and market performances. Even the debt in Greece can affect public employee retirement systems in America.

But members of the General Assembly, past and present, deserve more of the blame than any other factor for Kentucky not having enough assets on hand to cover retirement commitments they have made to public employees, retirees and their families.

Some politicians insist that we would not have the current massive unfunded actuarial liability problem had the General Assembly in recent years made its full actuarial required contribution (ARC) payments.

While full payment of the ARC is necessary for the systems’ solvency, at the same time it’s a red herring – perhaps unintended by some legislators, but a red herring nonetheless. When the pension systems come up short, regardless of the amount or reasons – whether bad actuarial assumptions, poor investment returns or the Legislature quietly piling on benefits – it doesn’t matter. The General Assembly through the ARC vessel is expected to pay the check, whatever the amount, and funding the ARC is a direct burden on Kentucky’s taxpayers. It’s a bottomless pit.

It's prominently written in legislative history: legislators are predictably greedy and shameless in altering the rules of the pension system to enrich themselves first and then to do the same for their government-employee constituents, which in turn increases the politicians' political power. He who makes the rules is first in line for the gold.

Of the six state-administered retirement systems, the legislators' pension benefits are the richest of them all, and as stated earlier, the most adequately funded. No surprise. But thankfully there are only 336 legislators (active, inactive and retired) in the legislators' retirement plan.

The damage, the massive and crippling \$31 billion unfunded actuarial liability comes mainly from four of the six systems – KERS, CERS, SPRS and KTRS. (See the chart on page 2.) But legislators have displayed the same carefree attitude toward them – bestowing benefits on the 463,283 members in those systems – as if the pension systems were just a bottomless source of gold to be dispersed at their discretion. Legislators regularly spike the pension and

medical benefits of their public employee constituents, handing out retirement benefits as if they were dividend coupons.

Of course, there are multiple cost drivers in the retirement systems such as healthcare inflation, double dipping, buying air time, padding final compensation to enhance pensions, low contribution rates, early retirement, greed and lack of political will and transparency, to mention a few.

However, it all comes back to the General Assembly. Public employees don't vote on giving themselves retirement benefits; legislators do. Public employees are not the ones stoking the run-away train. It's the legislators who have been feeding the coals, and only they, once the public ultimately demands reform will be able to return the state's public employee retirement systems to normalcy.

Lowell Reese is owner of Kentucky Roll Call, a public affairs publishing company in Frankfort, and a former state Chamber of Commerce executive.

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