THE CONNECTICUT POLICY INSTITUTE

A non-partisan, not-for-profit research organization dedicated to developing responsible, research driven public policy for Connecticut.

Connecticut's Public Pension Liabilities

-How Big Are They and What Can Be Done About Them -

September 14, 2012

Written by the staff of the Connecticut Policy Institute with special thanks for the technical support of Andrew Biggs (Ph.D., M.Sc., M.Phil.), Resident Scholar at the American Enterprise Institute, and Jeremy Gold (Ph.D., FSA), Proprietor of Jeremy Gold Pensions.

Table of Contents

I. Introduction……………………………...………………..…………………………….1

II. Summary of Policy Recommendations.……….……….………………….……………2

III. Rationale and Details of Policy Recommendations.……….......…………………..…….3

1. Lower the Discount Rate Used to Measure Pension Liabilities………………………..……...……………...…………...……...3

2. Reduce Pension Liabilities..……...…………………………….……..…..….6

3. Switch to a Defined-Contribution Pension Plan for New State Workers………………………..………………………………............11

IV. Conclusion: A Connecticut Plan of Action...……………………....……………14

Introduction

Connecticut's longterm pension and healthcare liabilities for its public employees are the sleeping giant of state policy challenges. When calculated using private sector accounting methods, Connecticut has more than $60 billion of unfunded liabilities across the state's three main pension benefit funds and its retiree healthcare benefits fund. When combined with Connecticut's roughly $20 billion in bonded debt, this is more than $80 billion of total state debt – nearly 40% of state GDP and the third highest debt per capita in the country.[1] This is no modest distinction, as many other state governments have gained more notoriety than Connecticut for their profligate accumulation of debt.

Debt that is due years in the future rarely generates the urgency of more immediate problems. But Connecticut's debt constitutes an emergency by any reasonable standard. Responsible leaders will treat it with a high sense of urgency because if Connecticut does not soon address its debt problem, the consequences for the state's residents will be very real and very painful, including future tax burdens damaging to the economy, cutbacks in essential services, default on state obligations, or a combination of all three. A liquidity crisis also looms if the debt markets lose confidence in Connecticut's ability to get control over its fiscal challenges.

Damage is already being done. Moody's recently downgraded its rating of Connecticut bonds, and businesses are investing less in the state and hiring fewer workers than they otherwise would. When combined with the federal debt, Connecticut's debt-GDP ratio exceeds the level at which economists believe government debt retards economic growth.[2] Tellingly, Connecticut's jobs recovery rate since 2009 has trailed that of the United States as a whole.[3]

To avoid damaging its economy further and letting down those who rely most on the state's services, Connecticut must act quickly to reign in its public employee pension liabilities. The first step is acknowledging the magnitude and seriousness of the problem, which the state has not yet done. For example, Connecticut's comptroller uses pension accounting methods that the federal government forbids in the private sector[4] and that probably understates the magnitude of the state's liabilities by over $20 billion.

---

[1] In terms of bonded debt alone, Connecticut has the highest debt per capita in the country. When bonded debt is combined with debt related to state retirees' pensions and other benefits, Connecticut has the third highest, after New Jersey and Alaska. For state debt per capita data across all states, see Andrew Guevara, "Report Reveals Aggregate State Debt Exceeds $4 trillion," State Budget Solutions (October 24, 2011), http://www.statebudgetsolutions.org/publications/detail/report-reveals-aggregate-state-debt-exceeds-4-trillion-2. Connecticut's GDP is roughly $200 billion. See Jim Glassman, "The State of Connecticut's Economy," J.P. Morgan Chase (June 30, 2012), https://www.chase.com/online/commercial-bank/document/Connecticut.pdf.

[2] See Carmen Reinhart and Kenneth Rogoff, "Too Much Debt Means the Economy Can't Grow: Reinhart and Rogoff," *Bloomberg* (July 14, 2011), http://www.bloomberg.com/news/2011-07-14/too-much-debt-means-economy-can-t-grow-commentary-by-reinhart-and-rogoff.html.

[3] See Ben Zimmer, "State Unemployment Rate Falls, But Jobs Still Lagging," *The Hartford Courant* (June 11, 2012), http://articles.courant.com/2012-06-11/news/hc-op-zimmer-malloys-unemployment-figures-not-ever-20120611_1_state-unemployment-rate-falls-jobs-outlook-national-rate.

[4] One exception to this is multi-employer pension plans.

This paper attempts to show a more accurate accounting of Connecticut's pension liabilities and to articulate the options the state has for reducing them. It also proposes a means for making the state's pension obligations for new workers more affordable to prevent a similar crisis from emerging in the future. These solutions are not without costs to public employees and other citizens of the state. But the aggregate cost of the solutions is far less than the cost if Connecticut's pension liabilities are not aggressively reduced.

Summary of Policy Recommendations

1. The state Treasurer must adopt accounting practices that accurately represent the magnitude of Connecticut's public pension liabilities. Specifically, the Treasurer should reduce its discount rate on future pension liabilities from the current rates of over 8% to 4-5%, a rate range typically used in the private sector. Some economists believe governments should use the long-term risk free rate, which today would be 2.5-3.0%.

2. Governor Malloy should begin a process of bargaining with the State Employees Bargaining Agent Coalition (SEBAC) to reduce Connecticut's pension liabilities in the following three ways:

    - Temporarily freeze and permanently reduce Cost of Living Adjustments (COLAs). (Potential liability reduction of up to $12 billion).

    - Increase employee contributions. (Potential liability reduction of up to $2 billion).

    - Eliminate loopholes in the state's pension benefit formula that allow public employees to artificially boost their benefits in the last years of employment and lower the pension benefits multiplier for as yet unvested benefits. (Potential liability reduction of up to $5 billion).

    In the event that these reforms cannot be agreed upon in collective bargaining, the General Assembly should enact them by statute.[5]

    All three of these adjustments have been effectively applied in other states. And in the states most aggressive about pension reform, these adjustments have applied not only to new hires but also to current employees. In some states, including Colorado, Kansas, Maine, and Rhode Island, among others, adjustments have applied to current retirees.[6] If pursued sufficiently aggressively, these three sets of reforms could reduce Connecticut's unfunded liability by up to $19 billion.

[5] For a discussion of these powers, see Jeanne Hayes & John Moran, "Comparison of Connecticut's State Employee Collective Bargaining Laws with Those of Bordering States," OLR Research Report (March 22, 2010), http://www.cga.ct.gov/2010/rpt/2010-R-0127.htm.

[6] Since it is only through the Connecticut General Statutes that public sector pensions are subject to collective bargaining, the General Assembly has the ability to modify those statutes to codify these reforms.

3. For new workers, Connecticut should abandon its defined-benefit pension plan and adopt a 401 (k) defined-contribution plan, which is the norm in the private sector and increasingly in the public sector. Defined contribution plans provide benefits in a more straightforward, transparent, and fiscally sustainable way because the cost of the benefits are expensed by the state at the time they are incurred. They also involve shifting some of the risks of retirement away from taxpayers and on to employees. To mitigate these risks, Connecticut's defined-contribution plan should include large employer contributions relative to salary, low-risk investment options that focus on bonds rather than stocks, and converting workers' account balances to annuities once they retire.

Rationale and Details of Policy Recommendations

1. Lower the Discount Rate Used to Measure Pension Liabilities

The first step to solving a problem is acknowledging it exists and assessing its magnitude. Unfortunately, when it comes to Connecticut measuring the unfunded portion of its pension liabilities, the state has not even achieved this modest first step.

According to the state's financial reports, Connecticut has roughly $40 billion of unfunded liabilities across its three main pension benefit funds and retiree healthcare benefit funds.[7] It is natural and understandable that most Connecticut residents accept this figure as accurate, especially since $40 billion of debt is hardly pocket change.

But these reports substantially understate the magnitude of Connecticut's future pension liabilities. If Connecticut used the same accounting practices that the federal government *requires* private sector firms to use when determining their pension liabilities, Connecticut's unfunded liabilities would be in excess of $60 billion.[8] If it used accounting practices recommended by many economists and actuaries, the state's unfunded pension liabilities would exceed $80 billion.[9]

Actuarial reports for pension funds are long and technical. But understanding how these reports understate Connecticut's unfunded liabilities is straightforward. Determining the future costs of a "defined-benefit" pension plan involves making actuarial assumptions about how long retirees will live and future compensation rates, among other things, to estimate the benefits the plan will be required to pay out each year in the future. The present value of those future costs (i.e. how much money would need to be invested today to pay for them) is the plan's "total liability." Subtracting from the total liability how much money the fund actually has results in the "unfunded liability."

---

[7] See figure 1, below.
[8] *Id.*
[9] *Id.*

The actuarial assumptions determining the plan's future costs normally do not result in substantive misstatements. The problem comes from the discount rate the state uses to calculate the return on invested funds. The higher the assumed discount rate the lower the liabilities, since less money would be needed on-hand now to cover benefits owed in the future.

In their calculations of Connecticut's liabilities, the treasurer assumes discount rates of 8.25% or higher.[10] The state justifies this assumption as reflecting "potential earnings" over a 30-year time horizon.[11] But 8.25% is likely too high a discount rate because it is simply not a realistic projection of likely future returns on investment. Economists project pension funds on average to return 6.5-7% per year over the next 30 years.[12] Even these rates may be too high based on current rates of return available in the debt and equity markets.[13] Several states have adjusted their discount rates to reflect lower expected returns.[14]

Moreover, given the risk structure of defined-benefit pension plans, most economists believe that liabilities should be discounted using a "riskless" interest rate of 2.5-3%, rather than the "expected return" rate of 6.5-7%.[15] This perspective spans the political spectrum, supported by actuaries[16] and experts at organizations as diverse as the American Enterprise Institute,[17] the Brookings Institution,[18] the Center for Retirement Research at Boston College,[19] State Budget Solutions,[20] and the Congressional Budget Office.[21]

---

[10] See figure 1, below, for the specific discount rate used for each plan.

[11] See Keith Phaneuf, "Report: Connecticut Was Among Nation's Worst at Saving for Public Benefits," *The Connecticut Mirror* (June 19, 2012), http://www.ctmirror.org/story/16676/report-connecticut-was-among-nations-worst-saving-public-benefits.

[12] See, for instance, Wilshire Consulting, "2012 Report on State Retirement Systems" (March 2012), http://www.wikipension.com/images/6/6e/Wilshire_2011.pdf.

[13] For instance, the 10-year annualized return of the S&P 500 Index through 2010 was 2.92%. See "Historical Annual Returns for the S&P 500 Index – Updated Through 2011," http://financeandinvestments.blogspot.com/2012/06/historical-annual-returns-for-s-500.html.

[14] See Paul Burton, "States Look at Lowering Assumed Pension Fund Return Rates," *The Bond Buyer* (Aug. 16, 2012), http://www.bondbuyer.com/issues/121_159/massachusetts-treasurer-steven-grossman-favors-lowering-assumed-rate-1043028-1.html.

[15] 30-year U.S. Treasury bonds, typically used to define riskless rates, currently have interest rates of roughly 2.75%. See U.S. Department of the Treasury, Resource Center: Daily Treasury Yield Curve Rates, http://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/textview.aspx?data=yield.

[16] See Jeremy Gold and Gordon Latter, "The Case for Marking Public Pension Plan Liabilities to Market," The Pension Finance Institute (August 2008), http://www.pensionfinance.org/papers/TheCaseforMarkingPublicPensionPlanLiabilitiestoMarket.pdf.

[17] See Andrew Biggs, "Understanding the True Cost of State and Local Pensions," American Enterprise Institute (February 13, 2012), http://www.aei.org/article/understanding-the-true-cost-of-state-and-local-pensions/; Andrew Biggs, "The Market Value of Public-Sector Pension Deficits," *Retirement Policy Outlook,* American Enterprise Institute (April 2010).

[18] See Douglas J. Elliott, "State and Local Pension Funding Deficits: A Primer," The Brookings Institution (December 3, 2010), http://www.brookings.edu/~/media/research/files/reports/2010/12/06%20state%20local%20funding%20elliott/1206_state_local_funding_elliott.pdf

[19] Munnell et al. "The Funding of State And Local Pensions In 2010," Center for Retirement Research at Boston College (May 2011), http://www.thefiscaltimes.com/~/~/media/Fiscal-Times/Research-

At the very least, Connecticut's treasurer should lower Connecticut's discount rate to the private sector discount rate range of 4-5%, the rate the federal government requires private companies with defined benefit pension plans to use.[22] Many pension experts believe even this rate is too high,[23] but it would be a major improvement over the 8.25-8.5% rates Connecticut currently uses.

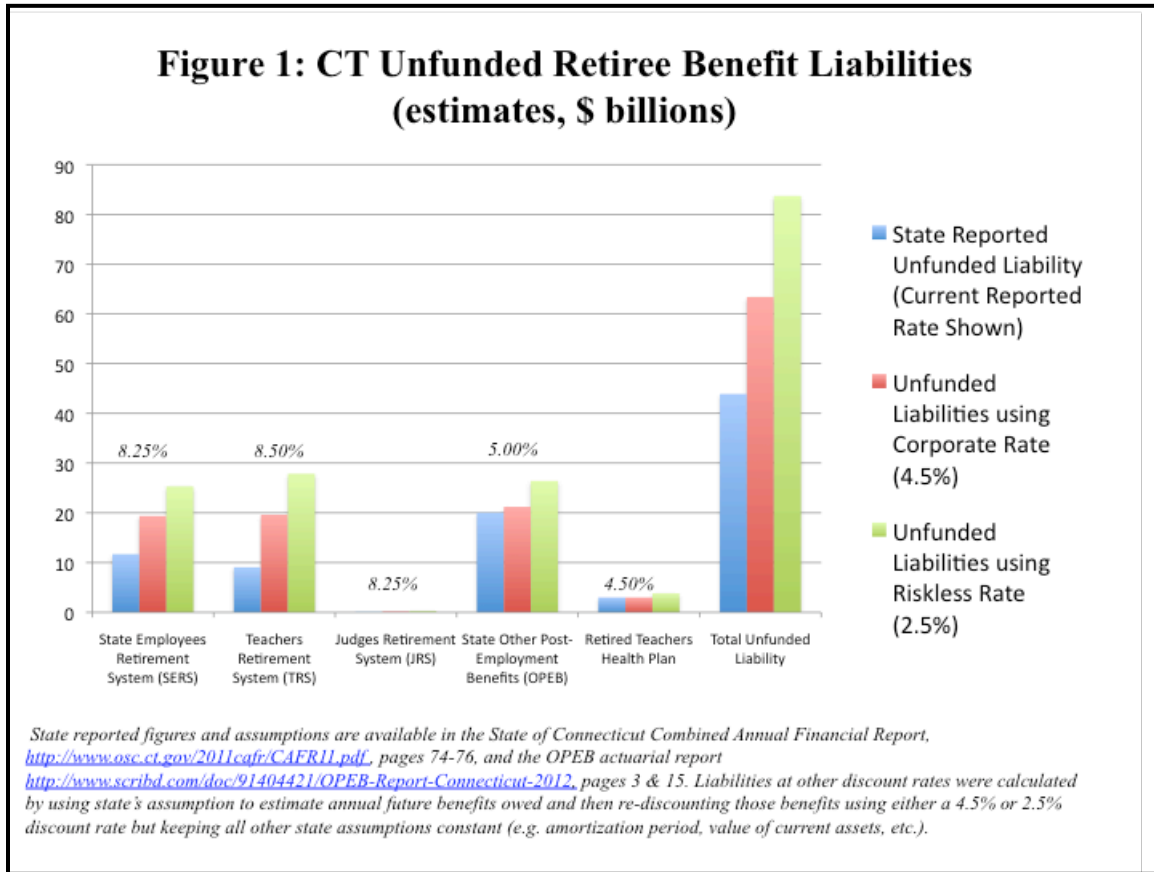


Figure 1: CT Unfunded Retiree Benefit Liabilities (estimates, $ billions)

State reported figures and assumptions are available in the State of Connecticut Combined Annual Financial Report, http://www.osc.ct.gov/2011cafr/CAFR11.pdf, pages 74-76, and the OPEB actuarial report http://www.scribd.com/doc/91404421/OPEB-Report-Connecticut-2012, pages 3 & 15. Liabilities at other discount rates were calculated by using state's assumption to estimate annual future benefits owed and then re-discounting those benefits using either a 4.5% or 2.5% discount rate but keeping all other state assumptions constant (e.g. amortization period, value of current assets, etc.).

Using unreasonably optimistic accounting assumptions not only understates the magnitude of Connecticut's pension liability crisis; it also opens the door for politicians to present "solutions" that are merely accounting gimmicks. In 2007, Governor Rell continued a longstanding Connecticut practice of issuing "pension obligation bonds" to

---

Center/Personal-Savings/2011/05/24/05-24-11-The-Funding-Of-State-And-Local-Pensions-In-2010.ashx?pid=%7B5786BD0C-E368-49B3-84A3-05FE38A82F61%7D.

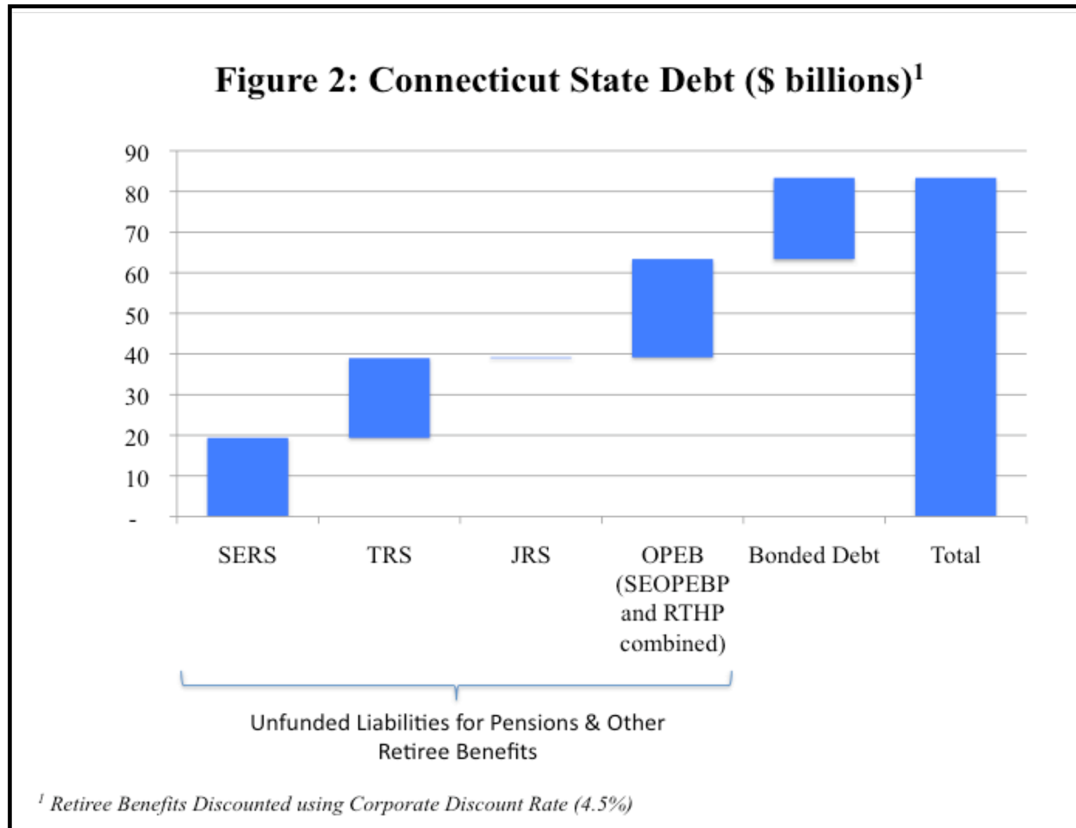
[20] See Bryan Leonard, "Just How Big are Public Pension Liabilities," State Budget Solutions (March 3, 2011), http://www.statebudgetsolutions.org/doclib/20110304_StatePensionLiabilityMarch4.pdf.

[21] Congressional Budget Office, "The Underfunding of State and Local Pension Plans" (May 2011), http://www.cbo.gov/publication/22042.

[22] The federal government requires private companies to use rates linked to corporate bonds, which currently provide interest rates of 4-5%.

[23] See, e.g., Jeremy Gold, "Comments to the ERISA Advisory Council," Society of Actuaries Pension Section Newsletter, September 2003 p. 7, *available at* http://users.erols.com/jeremygold/papers.html.

attempt to fund the state's pension obligations. The State issued these bonds at a 5.88% interest rate and placed the money raised into the pension funds, where it was invested under an assumed rate of return of 8.25%. This was seemingly a form of arbitrage – the difference between the rates of return could be pocketed as profit, helping to restore underfunded pension plans to health.[24] In reality, of course, the arbitrage is just a gimmick. The state cannot reasonably assume it can borrow at 5.88% and earn 8.25% without taking significant risks with those funds. If it could, the proverbial "money tree" would have sprouted in Connecticut and in addition to assuming away our pension obligations we could borrow even more and assume away the state's need for taxes!



2. Reduce Pension Liabilities

Reducing pension liabilities is challenging because it involves reducing benefits that have already been promised, recklessly or not, to government workers. However, if Connecticut does not reduce its unfunded liabilities, the state's residents will be on the hook for billions of dollars of tax increases and / or significant cuts in essential services such as public education, infrastructure maintenance, and social services.

[24] Keith Phaneuf, "Borrowing Ruled Out as Pension Fund Fix," *The Connecticut Mirror* (September 16, 2010), http://ctmirror.com/story/7712/officials-wary-bonding-bailout-state-employee-pensions.

Connecticut's public sector pension benefits are very generous, leading to lifetime compensation for public sector workers that far exceeds lifetime compensation for equivalent private sector workers. Controlling for age, race, and educational attainment, Connecticut's state employees receive on average salaries three percent lower than equivalent private sector workers.[25] However, differences in pension compensation between public and private sector workers more than make up for slightly lower salaries in the public sector.[26] Figure 3, below, lists the "normal cost" of the different tiers of the Connecticut State Employees Retirement System (SERS) calculated at a discount rate of 4.5%, which represents the value of benefits accruing to employees in a given year as would be calculated by a private sector employer. As the figure illustrates, during each year of employment Connecticut public employees receive, in addition to their salary, implicit "pension compensation" of 15-51% of salary depending on their plan Tier. By contrast, private sector employees typically receive 401(k) pension contributions from their employers of 4-6 percent of salary. As a result, Connecticut public sector employees now earn lifetime compensation that is higher than private sector lifetime compensation for an equivalent job by 8-42% with the weighted average being 31.5% higher.

Figure 3: Value of SERS Pension Benefits Accruing to Employees in a Given Year ("Normal Cost")[1]

SERS Plan Tier	**Normal Cost as a Percent of Salary (Estimates)** Discounted at 4.5% and Net of Employee Contributions – 5% for hazardous jobs, 2% for all others
Tier I - Plan B	41%
Tier I - Plan C	31%
Tier II – Hazardous	51%
Tier II – Others	27%
Tier IIA - Hazardous	31%
Tier IIA – Others	15%

[1] This is distinct from the actual benefits employees earn once they retire. Rather, it represents the implicit pension compensation employees receive during each year of employment, assuming that compensation would be invested at a guaranteed return of 4.5% to realize the benefits paid-out during retirement. The Congressional Budget Office recently used a similar approach in valuing the pensions received by federal government employees.

[25] Figure calculated through a wage regression using data in the Current Population Survey. Interestingly, this differential is much lower than the national average of 9%. See Alicia H. Munnel et al, "Comparing Compensation: State-Local Versus Private Sector Workers," Center for Retirement Research at Boston College (September 2011), http://crr.bc.edu/wp-content/uploads/2011/09/slp_20-508.pdf; Andrew Biggs, "Comments on 'Comparing Compensation: State-Local Versus Private Sector Workers,'" (September 16, 2011), available at http://www.aei-ideas.org/wp-content/uploads/2011/09/Biggs-response-to-CSLGE-public-pay-paper3.pdf.

[26] It is worth noting that nationally, lifetime compensation public workers may not exceed lifetime compensation for equivalent private workers. This is because the private sector salary premium is lower in Connecticut than in many other states, and because Connecticut's public sector pension benefits are particularly high. For a general discussion of this topic, see reports cited in note 23, above. But it is important to note that the Connecticut-specific calculations done for this paper are of more relevance to Connecticut than general national statistics or discussions of other states.

To bring pension costs in-line with today's more affordable standards, Connecticut should enact the following three reforms, following the lead of other states that passed similar reforms.

1. Temporarily suspend and permanently reduce "cost of living adjustments" (COLAs).

   COLAs are automatic annual increases to pension benefits ranging from 2% to 7.5% per year, depending on inflation rates and the particular pension package a worker chooses.[27] The 2011 collective bargaining agreement with SEBAC reduced the minimum adjustment (i.e., the annual increase to benefits that occurs irrespective of actual inflation) from 2.5% to 2% for some new retirees. But many states under both Democrat and Republican leadership have implemented far more aggressive revisions to their automatic COLA provisions, often suspending them altogether until public pensions get on better footing.[28]

   For instance, Rhode Island's recently passed Retirement Security Act suspends annual COLAs until the state's pension plans are at least 80% funded.[29] At that point, adjustments will be capped at 4% and will apply only to a retiree's first $25,000 of pension income.[30] Similarly, Maine has suspended COLA increases for three years, after which annual increases will be capped at 3%.[31] All told, since 2009 eleven states have substantially reduced their COLAs for the pensions of current retirees, and another five have reduced them for current employees.[32] Connecticut's own State Post-Employment Benefits Committee recommended in 2010 that Connecticut *cap* annual COLA increases at two percent, the current minimum.[33]

   According to Gabriel Roeder Smith & Co., an actuarial and pension consulting firm, each 1 percentage point of additional COLA can add more than 7% to a plan's total costs.[34] This means that if Connecticut were to freeze COLAs until its plans are at

[27] See Cavanaugh MacDonald, "Connecticut State Teachers' Retirement System Annual Actuarial Valuation as of June 30, 2010," p. 23, http://www.ct.gov/trb/lib/trb/formsandpubs/actuarial_valuation_rep_2010.pdf; Cavanaugh MacDonald, "Connecticut State Employees Retirement System: Report of the Actuary on the Valuation Prepared as of June 30, 2011," p. 26, http://www.osc.ct.gov/rbsd/reports/SERSActVal2011.pdf.
[28] See Ronald K. Snell, "Pensions and Retirement Plan Enactments in 2011 State Legislatures," National Conference of State Legislatures (January 31, 2012), http://www.ncsl.org/issues-research/labor/2011-pension-and-retirement-enacted-legislation.aspx.
[29] See Rhode Island Senate: S-1111 Substitute A, As Amended, http://www.rilin.state.ri.us/BillText/BillText11/SenateText11/S1111Aaa.pdf .
[30] See Executive Summary, followed by "Actuarial Analysis of the Rhode Island Retirement Security Act of 2011, as described in S1111A and H6319A," Gabriel Roeder Smith & Co. (November 14, 2011), http://www.pensionreformri.com/resources/ReportwithGRSAppendix.pdf.
[31] Ronald K. Snell, "Pensions and Retirement Plan Enactments in 2011 State Legislatures."
[32] See Hazel Bradford, "Strapped State Pension Funds Take Scalpel to COLAs for Relief," *Pensions & Investments* (June 11, 2012), http://www.pionline.com/article/20120611/PRINTSUB/306119977.
[33] Connecticut State Post-Employment Benefits Commission, "Final Report" (October 28, 2010), p. 49, http://www.ct.gov/opm/lib/opm/secretary/opeb/peb_final_report.pdf.
[34] See Bradford, *supra* note 33.

least 80% funded and permanently cap them at 2%, it could reduce total liabilities by up to 20%, or $12 billion.[35]

2. Increase employee contributions.

   Although workers in a defined-benefit pension plan do not contribute directly to their own pensions, current employees are required to contribute a portion of their salaries to the state's general pension funds. Employee contributions are typically a meaningful funding component of a defined-benefit plan, yet Connecticut requires substantially lower contributions from its employees than most other states. Most New England states have employee contribution rates between 5 and 9 percent.[36] Connecticut's employee contribution rate is 2% for all employees except hazardous duty workers who contribute 5% and teachers who contribute 6%.[37]

   While the national pension crisis has inspired many states to increase their employee contribution levels, Connecticut has done nothing to increase the contributions of current employees. The most recent collective bargaining agreement raises the employee contribution rate to 5% only for new employees, which has no impact on current liabilities. Moreover, even among new employees this increase applies only to higher education employees, a tiny fraction of the government workforce.[38]

   In contrast, in the last two years twenty-nine states have increased the contribution levels of current *and* future employees.[39] Alabama raised the employee contribution rate for teachers and state employees from 5% to 7.25-7.5%. Colorado recently increased its contribution rate for state troopers from 10% to 12.5% and for all other state employees from 8% to 10.5%.[40]

   If Connecticut were to set the contribution rate for all employees to 6%, the current rate for teachers and still at the lower end nationally, it would reduce the state's unfunded liabilities by up to $2 billion.[41]

3. Eliminate loopholes in the formula used to determine an employee's pension benefit.

   Connecticut's formula for determining a retiree's pension benefit involves two factors. First, the retiree's five highest-salaried years of employment (including overtime and

---

[35] $12 billion is about 20% of Connecticut's total (not unfunded) pension liabilities (excluding healthcare liabilities and using 4.5% discount rate).
[36] Connecticut State Post-Employment Benefits Commission, "Final Report," *supra* note 34, page 44.
[37] See sources cited in footnote 28, above.
[38] Office of the State Comptroller, "Connecticut State Employees Retirement System: Hybrid Plan Summary Plan Description," http://www.osc.ct.gov/empret/hybridspd/hybridplan.htm.
[39] Ronald K. Snell, "Pensions and Retirement Plan Enactments in 2011 State Legislatures," National Conference of State Legislatures (Jan. 31, 2012), http://www.ncsl.org/documents/employ/2011EnactmentsFinalReport.pdf.
[40] *Id.*
[41] Estimates based on employee contribution data in SERS and TERS actuarial reports cited in footnote 28, above.

unused sick leave) are averaged to determine the "final average salary." Second, a pension multiplier related to the number of years the retiree worked is applied to that final average salary. For pension benefits that have already vested, this benefits formula cannot legally be changed, except in a fiscal emergency. But many states in recent years have revised their formulas for current workers' non-vested pension benefits (which are included in the calculation of a state's current liabilities).

Connecticut's pension multiplier is roughly in line with the national average of 1.8% per year of service.[42] However, it remains higher than the multipliers in states that have been most aggressive about controlling pension costs. Rhode Island recently lowered its pension multiplier to 1% per year of service.[43] Pre-reform multipliers in Rhode Island ranged from 1.6% to 3% per year of service, depending on a retiree's specific plan.[44] Multipliers closer to 1% also were the norm nationally prior to the tech bubble of the late 1990s, when public sector unions lobbied to increase them in line with economic growth.[45] In subsequent years with lower growth, pension multipliers have not been reduced accordingly.

Connecticut's pensions are based on only the highest years' salary, so many state workers engage in so-called "pension padding" – working extra overtime in their last year or two on the job to significantly boost retirement income. A recent investigative report by the Hartford Courant found this practice to be "widespread" in Connecticut. In several instances workers earned lifetime annual pension benefits 20% higher than their highest year's base pay by loading-up on overtime in the 2-3 years prior to retirement.[46]

Connecticut needs to close this loophole – either by basing pension benefits on employees' salaries over their career, or by eliminating or capping overtime pay in the "final average salary" determination. If Connecticut were to lower its pension

---

[42] See Department of Legislative Services, Maryland: "Presentation to the Employees' and Retirees' Benefit Sustainability Commission," (October 2010). In Connecticut the pension multiplier is 1.3% per year of employment for the first thirty-five years and 1.63% per year for every year thereafter. See Richard Urban, "The Pension Bomb," *Connecticut Magazine* (February 2010), http://www.connecticutmag.com/Connecticut-Magazine/February-2010/The-Pension-Bomb/index.php?cparticle=2&siarticle=1; Office of the State Comptroller, http://www.osc.ct.gov/empret/ (includes specific plans). However, Connecticut adds an additional 0.5% multiplier to every dollar of the final average salary in excess of a pre-determined annual "breakpoint" salary. See, for example, http://www.osc.ct.gov/empret/tier3spd/tier2asumm/tier2asumm.pdf (applies to all Tier II and Tier III plans).

[43] See Executive Summary, followed by "Actuarial Analysis of the Rhode Island Retirement Security Act of 2011, as described in S1111A and H6319A," Gabriel Roeder Smith & Co. (November 14, 2011), http://www.pensionreformri.com/resources/ReportwithGRSAppendix.pdf.

[44] See "What Are the Rhode Island Pension Reforms?" The Civic Federation (April 19, 2012), http://www.civicfed.org/iifs/blog/what-are-rhode-island-pension-reforms.

[45] See Gerard Miller, "In Search of a Fair Pension Formula" (October 22, 2009), http://www.governing.com/columns/public-money/In-Search-of-a.html; Financial Strategies for First Responders, "History of the Pension Multiplier," http://www.heroicinvesting.com/history-of-the-pension-multiplier/.

[46] See John Lender, "Government Watch: OT Inflation Pervades State Pension System," *Hartford Courant*, December 17, 2011, http://articles.courant.com/2011-12-17/news/hc-lender-column-pensions-1218-20111217_1_pension-formula-pension-base-state-pension-system.

multiplier to 1% and eliminate pension padding, it would reduce its total liability by up to $5 billion.[47]

The precise savings Connecticut can receive from these three sets of reforms depends on which the state chooses to adopt, and how aggressively. But if Connecticut pursues all three aggressively enough, it could reduce its unfunded liabilities by up to $19 billion, a more than 20% reduction in the state's total debt. This would bring Connecticut's debt per capita closer to national averages and place the state on much sounder financial footing to grow its economy and create jobs.

3. Switch to a Defined-Contribution Pension Plan for New State Workers

Whatever Connecticut does about its already accumulated liabilities, the current crisis has exposed the un-sustainability of Connecticut's current pension system. Unless Connecticut wants to see its pension liabilities get even further out of control, it needs to offer new state employees a more transparent and fiscally viable system of retirement benefits. Reforms that affect only new workers will not reduce Connecticut's current liabilities. But they can provide more substantial savings in the future than changes to current workers' benefits, since they do not require modifications to promises the state has already made.

The most straightforward, transparent, and fiscally sustainable way for Connecticut to reform its pension system is to switch from a defined-benefit to defined-contribution plan such as a 401 (k). In defined-contribution plans the employer, employee, or both contribute a certain amount of money each year to the employee's personalized account.[48] This money is then invested. Upon retiring, workers gain access to the funds in their accounts. While defined-contribution plans are currently not the norm in the public sector,[49] most private sector companies have switched to them in the last thirty years. The Pew Center estimates that by 2016, only 13% of private sector workers will remain enrolled in defined-benefit plans.[50]

Defined-contribution plans are preferable in the public sector for several reasons. First, defined-contribution plans are more transparent to workers and taxpayers because the government must fund the pension expense at the time the obligation is incurred, requiring that it be expensed currently on state budgets. Politicians are unable to understate pension costs through questionable actuarial assumptions or by exploiting

---

[47] Assumes 25% reduction in total liabilities attributable to current workers. Based on data contained in actuarial reports cited in note 28, above.
[48] See "Defined-Contribution Plan," Investopedia. http://www.investopedia.com/terms/d/definedcontributionplan.asp#axzz1yRGL99Fo
[49] See Ronald Snell, "State Defined Contribution and Hybrid Pension Plans," National Conference of State Legislatures (June 2010), http://www.ncsl.org/LinkClick.aspx?fileticket=yGsmFhwoq7E%3D&tabid=18511.
[50] See Barrett, Greene et al. "Promises with a Price: Public Sector Retirement Benefits," The Pew Center on the States, http://www.pewstates.org/uploadedFiles/PCS_Assets/2007/Promises%20with%20a%20Price.pdf.

accounting loopholes. Nor can they make reckless promises to workers and postpone recognition of the costs of those promises until after the politician is no longer in office. Second, defined-contribution plans are always fully funded since the size of the pension fund and the retiree benefits owed are by definition the same. Finally, defined-contribution plans align the risks and rewards of saving and investing for retirement, rather than requiring taxpayers to bear all the investment and actuarial risks of public sector employees' pensions.

Defined-contribution plans have their own risks. Several pension scholars express concerns that workers in defined-contribution plans may save insufficiently for retirement.[51] This risk can be reduced through structural features of plans, including large employer contributions relative to salary, low-risk investment options that focus on bonds rather than stocks, and converting employee's account balances to annuities once they retire. Plan sponsors can also pay closer attention to how 401(k) contributions are invested to ensure that investments are not mismanaged. In the private sector, more than 64.4% of plan sponsors review plan investments quarterly, with 60.1% offering investment advice to participants.[52] A large number of funds allow their participants the option of investing in safer fixed-interest securities.[53]

As a result of these considerations, several states and municipalities have been moving towards defined-contribution plans for new workers. Utah has recently introduced a defined-contribution plan for new employees with immediately vesting annual employer contributions of 12% of salary for fire and safety workers and 10% for others.[54] In 2006, Alaska implemented a mandatory plan for new state employees and teachers. Members contribute 8% of their salary, and employers contribute an additional 5-7%.[55] In New York, the State University of New York system has given its employees the choice between a traditional defined benefit plan and a defined contribution plan since 1964.[56] Employees joining the defined-contribution plans contribute 3% of salary during their first ten years of service, and nothing thereafter. Employers contribute heavily – 8% of earnings during the first seven years of a new hire's service, 10% for the next three years, and 13% each year thereafter.[57] The plan also offers annuity contracts that promise payments for the rest of the retiree's life.

---

[51] See Andrew Biggs, "Public Sector Pensions in Nebraska: Are Cash Balance Plans the Answer?", Platte Institute for Economic Research (October 2011), p. 3, http://www.platteinstitute.org/docLib/20111212_Public_Sector_Pensions_in_Nebraska.pdf.
[52] See "PSCA Releases 53rd Annual Survey of Profit Sharing and 401(K) Plans," *Marketwire* (September 17, 2010), http://www.marketwire.com/press-release/PSCA-Releases-53rd-Annual-Survey-of-Profit-Sharing-and-401K-Plans-1320932.htm
[53] See Hilery Simpson, "How Does your 401(k) Match Up?" U.S. Department of Labor, Bureau of Labor Statistics (May 26, 2010), http://www.bls.gov/opub/cwc/cm20100520ar01p1.htm
[54] See Bryan Leonard, "Utah: Pension Reform that Works," State Budget Solutions (June 1, 2011), http://www.statebudgetsolutions.org/publications/detail/utah-pension-reform-that-works.
[55] See "Alaska PERS/TRS Defined Contribution Retirement Plan," Center for Retirement Research at Boston College (April 2011), http://crr.bc.edu/wp-content/uploads/2011/09/Alaska-2.pdf
[56] See E.J. McMahon, "Optimal Option: SUNY's Personal Retirement Plan As a Model for Pension Reform," Empire Center for New York State Policy (February 12, 2012) http://www.empirecenter.org/Documents/PDF/Optimal%20Option.pdf
[57] *Ibid.*

Other states have divided retirement benefits between defined-contribution and defined-benefit plans, allowing them to reduce their defined benefit plans substantially. Rhode Island transferred all current pension plan members as of July 1, 2012 to a hybrid composed of a reduced defined benefit plan supplemented by a defined contribution plan.[58] In this new pension system, both members and employers are required to contribute to individual member accounts – contributing five percent of worker salary and one percent, respectively.[59] Employees contribute an additional part of their salary to the defined benefit portion of the plan, although this contribution was reduced from 8.75% to 3.75% of earnings.[60] All employee contributions vest immediately, while employer contributions vest after three years.

These states' approaches stand in stark contrast with Connecticut's version of a "hybrid" pension plan. Connecticut's 2011 SEBAC collective bargaining agreement included a provision for new employees in higher education that allowed them to choose *at the time of retirement* (rather than when they start work) whether to take the benefits owed to them under the state's standard defined-benefit plan (with slightly higher employee contributions) or a market return on their contributions plus a five percent employer match with four percent interest.[61] This does nothing to increase transparency and accountability, lower the state's liabilities, or reduce the defined-benefit plan's risks to taxpayers. Rather it maintains all the downsides of a defined-benefit plan while simply allowing public retirees to reap even higher benefits than they otherwise would when the economy is doing well.

Connecticut would do far better adopting a defined-contribution plan for all new employees, following the lead of the Utah, Alaska, and SUNY plans. The SUNY plan provides a particularly useful model since, as discussed above, it includes many safeguards to help workers manage their retirement benefit risks. Connecticut could also look to its own Connecticut Alternate Retirement Program (CARP) a defined-contribution plan available only to a tiny fraction of the workforce (unclassified employees in higher education). In this plan, members are required to contribute 5% of their annual salaries and the state makes an additional 8% contribution.[62] The State needs to expand this plan or implement a new one open to all employees and required for new hires.

---

[58] See Ronald Snell, "Pensions and Retirement Plan Enactments in 2011 State Legislatures," http://www.ncsl.org/issues-research/labor/2011-pension-and-retirement-enacted-legislation.aspx

[59] See Executive Summary, followed by "Actuarial Analysis of the Rhode Island Retirement Security Act of 2011, as described in S1111A and H6319A," Gabriel Roeder Smith & Co. (November 14, 2011), http://www.pensionreformri.com/resources/ReportwithGRSAppendix.pdf

[60] *Ibid.*

[61] See Office of the State Comptroller, http://www.osc.ct.gov/empret/hybridspd/HybridPlanSPDFinal.pdf; and Revised SEBAC 2011 Agreement between State of Connecticut and State Employees Bargaining Agent Coalition, http://inthistogetherct.org/wp-content/uploads/2011/07/Revised_SEBAC_2011_TA.pdf.

[62] See Office of the State Comptroller, "Comprehensive Annual Financial Report: Fiscal Year Ended June 30, 2011," p. 74, http://www.osc.ct.gov/2011cafr/CAFR11.pdf

Defined-contribution plans need not involve giving employees less compensation or reducing the ratio of salary to retirement benefits. They simply involve funding pension liabilities and shifting investment and other actuarial risks to employees while providing those benefits in a more transparent and accountable way. It is telling that in New York's SUNY system, where workers can choose between defined-contribution defined-benefit options, 71% select defined-contribution.[63] Properly designed, defined-contribution plans in the public sector are a win-win for workers and taxpayers.

Conclusion: A Connecticut Plan of Action

Connecticut's public pension system is broken. Solutions that simply tinker around the edges will not fix it. Here are seven things Connecticut should do to place our public sector pensions on a more sound and affordable footing:

- Use an appropriate discount rate for future pension liabilities. Most conservative would be a riskless rate of 2.5-3%. Alternatively, it could be the private sector norm of 4.5-5%.
- Freeze each pension plan's cost of living adjustments (COLAs) until the plan is at least 80% funded.
- Permanently cap all cost of living adjustments at 2% per year.
- Raise employee contribution rates to 6% for all employees, in line with national averages. Connecticut teachers already contribute at this rate.
- Lower the pension multiplier to 1% of "final average salary" per year of service.
- Thwart "pension padding" by eliminating or capping overtime pay in the "final average salary" determination.
- Switch to a defined-contribution plan for all new workers, with risk-mitigation features such as large employer contributions relative to salary, low-risk investment options that focus on bonds rather than stocks, and converting the employee's account balances to an annuity once they retire.

The fund discount rate can be changed at the discretion of the state Treasurer's office. The other solutions are currently subject to collective bargaining between the Governor and SEBAC. However, the Connecticut General Assembly has the power to enact them by statute. If real reform cannot be achieved through collective bargaining, the legislature should take the requisite action.

[63] E.J. McMahon, "Optimal Option: SUNY's Personal Retirement Plan As a Model for Pension Reform," http://www.empirecenter.org/html/2012/02/optimaloption2.cfm.

Fundamental pension reform may seem like a tall order, but the experience of other states has shown that it can be achieved when state leaders have the will. In Rhode Island, Treasurer Gina Raimondo recently spearheaded the successful passage through a Democrat-controlled legislature of one of the country's more aggressive reform plans to-date. In her own words, Treasurer Raimondo ignored advice to avoid the issue "because it is politically challenging and it's kind of the third rail" and instead "walk[ed] into the belly of the beast" and made public workers confront the reality that they "were lied to [by former politicians] and the system is broken." Treasurer Raimondo traveled the state articulating the dire consequences if unfunded liabilities were not reduced – workers and property owners would face new taxes, and government spending to services such as homeless shelters, public libraries, and public transportation would all be cut.[64]

When the Utah state pension fund lost 22% of its assets in 2008, state lawmakers didn't attempt to make excuses or explain away they problem. They commissioned a report that explained how the fund was actually in even more precarious shape than they realized because of the unreasonably high discount rate used. Lawmakers responded by fundamentally reforming the system and adopting a defined-contribution plan for new workers.[65]

It is time for Governor Malloy, Comptroller Lembo, and the Connecticut General Assembly leadership to adopt aggressive public sector pension reforms to save Connecticut from the serious adverse consequences of failing to do so.

[64] See Allysia Finley, "The Democrat Who Took on the Unions," WSJ Online, March 25, 2012, http://online.wsj.com/article/SB10001424052970204136404577207433215374066.html?mod=WSJ_Opinion_LEADTop.

[65] "The Utah Pension Model: The State Adopts 401(k)s for New State Employees," *Wall St. Journal*, Jan. 19, 2011, http://online.wsj.com/article/SB10001424052748703583404576080260001386474.html.