

Oct. 2003
No. 14

Pension programs nationally are experiencing large financial shortfalls.

Workers expect pension income to be their largest source of retirement income.

The rising cost of health care is straining pension programs.

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Retirement Systems Will Require a Bigger Share of State Funds

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Public and private pension programs across the country are experiencing financial shortfalls, a situation that workers, retirees, taxpayers, and policymakers will be dealing with for years to come. Here, we present our analysis of Kentucky's largest public employee retirement systems and some possible long-term fiscal consequences. We estimate that by 2014 between 5% and nearly 8% of combined General and Road Fund revenue could be going to the retirement systems, compared to just over 4% in 2002.

National surveys reveal that many Americans are depending on pension income for their retirement and are worried about their financial security. A 2003 survey of working Americans found that the single most important source of expected retirement income is "money provided by an employer through a pension."¹ Yet, survey results suggest that some do not feel financially secure despite the promised steadiness of a monthly pension check. A Gallup poll conducted last spring found that a little more than half of all Americans are either very worried (24%) or moderately worried (30%) about having enough money for retirement.²

Rising health care costs, a sluggish economy, volatile financial markets, and state budget shortfalls have exerted intense pressure on pension programs. The Pension Benefit Guaranty Corporation (PBGC), the federal agency that insures over \$2 trillion in projected benefits in 33,000 private pension plans, reports that these plans are underfunded by an estimated \$300 billion,³ a substantial increase from the 1999 estimate of \$23 billion.⁴ Public employee retirement systems are similarly weak. In a study of 123 state retirement systems, Wilshire Associates found that 79 percent were underfunded in 2002 by an estimated \$180 billion.⁵

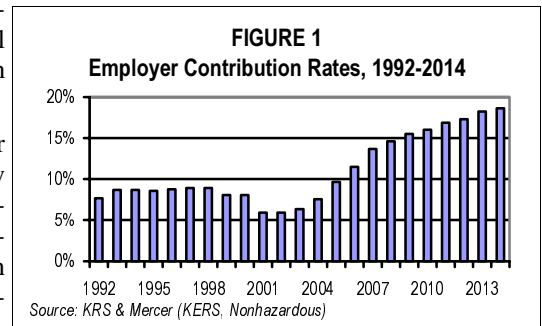
In Kentucky, we have numerous private pension plans, as well as 19 state and local public employee retirement systems with over 250,000 members and nearly 90,000 beneficiaries (see Table 1). The largest of these are the Kentucky Teachers Retirement System (KTRS) and the various plans administered by the Kentucky Retirement System: the Kentucky Employee Retirement System (KERS); the County Employee Retirement System (CERS); and the State Police Retirement System (SPRS). During the 2001-02 fiscal year, these systems paid almost \$1.4 billion in pension benefits.⁶

According to Wilshire Associates, employer contributions to state pension plans will "likely increase by two or three times over the next several years as efforts are made to eliminate unfunded liabilities." The employer contribution rate is a percentage of the workers' wage or salary paid into the retirement system. The recommended employer contribution rates for Kentucky's public employee retirement systems are expected to increase significantly. For example, the rate in fiscal year 2001-02 for KERS (nonhazardous) was 5.89%, and currently the actuary-projected rate for 2014 is 17.76% (see Figure 1).⁷

TABLE 1
Characteristics of Selected Kentucky Public Employee Retirement Systems, FY 2000-2001

System	Active Members	Inactive Members	Beneficiaries
KERS (Nonhazardous)*	47,780	16,741	25,118
KERS (Hazardous)*	4,228	922	1,053
CERS (Total)*	78,773	28,356	24,415
CERS ("School-Board")*	44,900	16,200	13,900
SPRS*	1,016	90	842
KTRS**	53,570	5,710	31,761
Other	9,588	7,655	4,983
Total***	194,955	59,474	88,172

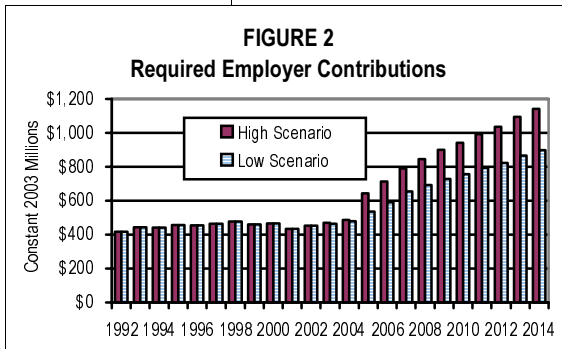
Source: *Kentucky Retirement Systems. **Kentucky Teachers Retirement System. ***U.S. Census Bureau. Note: CERS School-Board is estimated.



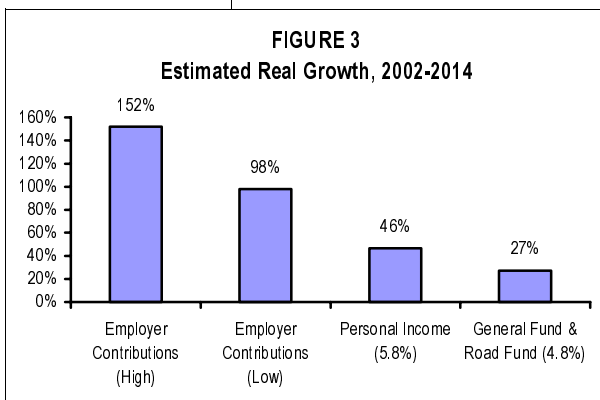
We focused our analysis on the state's largest public employee retirement systems: KTRS, KERS (hazardous and nonhazardous), CERS ("school board" portion),⁸ and SPRS. Employer contributions in 2002 to these retirement systems were \$453 million (in constant 2003 dollars). To estimate future amounts we generated multiple scenarios based on two fundamental factors, the employer contribution rates and covered payroll:

- **Employer Contribution Rate** — The employer contribution, along with investment gains and the employee contribution, fund the retirement systems.⁹
- **Covered Payroll** — Covered payroll is affected by pay increases and the size of the workforce.¹⁰

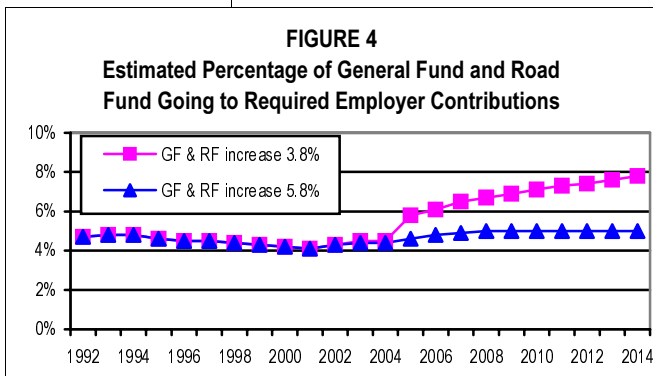
Two scenarios are illustrated in Figure 2, with each showing a large increase in employer contributions. In fact, by 2014 they would increase to \$898 million in the low scenario and \$1.142 billion in the high scenario (in constant 2003 dollars). The estimated real growth in employer contributions from 2002 to 2014 is 152% in the high scenario and 98% in the low scenario. By comparison, if the state's total personal income increased at an average annual rate of 5.8% and the combined general and road funds increased at an average annual rate of 4.8% during the same period, then their estimated real growth would be 46% and 27%, respectively (see Figure 3).



These increases imply, of course, that an increasing share of the General and Road Funds will be requested to support the retirement systems. We estimate by 2014 about 5.0% in the low scenario and 7.8% in the high scenario, compared to about 4.3% in 2002 (see Figure 4).¹¹



Ultimately, the actual long-term outcomes will likely, but not necessarily, lie between these two scenarios. The low scenario represents only a marginal increase in General and Road Fund revenue going to the retirement systems. In this scenario we assume relatively high investment returns,¹² slightly lower increases in covered payroll than the 1990s,¹³ no additional money for the financially vulnerable medical insurance fund for retired teachers, and a robust increase in general and road fund revenue¹⁴ (which would likely require significant tax modernization to achieve). On the other hand, the high scenario represents a near doubling in General and Road Fund revenue going to the retirement systems. This scenario assumes a much lower investment return,¹⁵ a continuation of increases in covered payroll similar to the 1990s,¹⁶ increased funding for the retired teachers medical insurance fund,¹⁷ and a somewhat anemic annual increase in the General and Road Funds.¹⁸



The cost of Kentucky's public pension funds could become an increasingly important public policy issue in the future. Aging public employees will only increase in number and the cost of health care for these public employees, who already tend to have high utilization rates, will only continue its relentless climb. As an increasing share of state funds goes to the retirement systems, it could begin to affect other vital public services. Thus, managing the cost of benefits to Kentucky's public retirees will require a careful eye and an artful touch.

¹2003 Retirement Confidence Survey, Employee Benefits Research Institute and the American Savings Education Council, available at: <http://www.ebri.org/rcs/2003/>. ²Raksha Arora, "Americans, Canadians Face Retirement in the Red," The Gallup Organization, August 12, 2003. ³Douglas Holtz-Eakin, CBO, "The Economic Costs of Long-Term Federal Obligations." ⁴Robert Samuelson, "The Pension Time Bomb," *The Washington Post*, 16 July 2003. ⁵2003 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation, Wilshire Associates, Inc., March 2003, available at: <http://www.wilshire.com/Company/2003_State_Retirement_Funding_Report.pdf>. ⁶The KRS paid \$650 million and the KTRS paid \$739 million. ⁷This assumes an investment return of 7.5%. The actuary-projected rates are shown in the technical appendix (pages 1-2), which is available at: <http://www.kltprc.net/policynotes/pn14techinfo.htm>. Also, the actuary-projected rate of 17.76% in 2014 for KERS nonhazardous has been revised to 17.85%. This is because the assumed rate for 2003-2004 was 7.53%, but the budgeted amount is lower at 5.89%. ⁸The so-called "school board" portion, which includes school board members, school bus drivers, and cafeteria workers, accounts for about 41 percent of the CERS (nonhazardous) total payroll and 57 percent of membership. We include it in our analysis because state government, not the county governments, pays the employer contribution to the retirement fund. ^{9,10}Refer to the technical appendix (see note 7). ¹¹Refer to the technical appendix (page 6) for an explanation of the estimation method (see note 7). ¹²8.25% for KRS, which is the actuarial-assumed rate of return. ¹³The average annual rate of change in covered payroll (KTRS, KRS Haz and Nonhaz, CERS "school board," and SPRS) is 4.3% in the low scenario, which is slightly below the 1990s average of 4.6%. ¹⁴5.8%. ¹⁵This is the "variable rate": -1.7% for 2002-2003, 5.58% for 2003-2004, 7.21% for 2004-2005, and 7.38% for 2005-2006 to 2011-2012. ¹⁶See note 13. In the "high scenario" covered payroll increases 4.5% annually. ¹⁷We use the 10-year scenario developed by Buck Consultants for the KTRS, which entails a 3.64% increase in the employer contribution rate. ¹⁸3.8%.