TO: The Kentucky State Legislature
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SUBJECT: Establishing a Sustainable Path Forward for Kentucky Pensions
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Background

Over the past 20 years, Kentucky's unfunded liability grew at an alarming rate, largely due to missed payments, irresponsible investment practices, and poor actuarial assumptions. In 2013, significant changes were made. This notably included the establishment of a Tier 3 for the Kentucky Retirement Systems (KERS) non-hazardous employees, which is a hybrid cash balance plan. Since 2017, full funding of the Annually Required Contribution (ARC) has resumed. The KRS Board of Trustees also drastically lowered actuarial assumptions in 2017 from 6.75% to 5.25% for the rate of investment return and from 4% to 0% for the rate of payroll growth. These are the most conservative assumptions among the 129 state pension plans in the country. These assumptions determine the contribution rates employers in the plan must make to keep them solvent. By extension, dropping the assumptions this drastically resulted in a dramatic increase in contribution rates for employers. In the main state government pension plan, the contribution rates soared from 49.5% to 83.4% of payroll. With that being said, KRS has failed to increase revenue alongside the rising costs of future benefits. KRS trustees have also neglected to consider the life expectancy change over the years and adjusting the retirement age for employees to fairly match it. This highlights how transparency and accountability must be considered when aiming to strengthen the KY pension systems.

Problem Definition

Kentucky's pension system is among the worst-funded in the country. Kentucky Retirement Systems are collectively only 46.3% funded (KCEP), with some of the individual plans falling well below this average. In total, the KY pension plans have an estimated $40 billion in unfunded liability. Normal employer costs for actual benefits remain fairly low, but the payments towards the unfunded liability are putting a significant strain on employers. The current situation is harming our economy, as demonstrated by the way Kentucky's pension debt has been blamed for multiple downgrades of Kentucky's recent bond ratings.

Pensions are an essential component of attracting a qualified, talented state workforce because according to a 2012 KCEP study, public sector employees receive 12.8% less in total annual compensation than comparable private sector employees. A pension, along with other benefits, allows the state to remain a competitive employer. Additionally, Kentucky teachers are not paying into Social Security, so their pension is their only public source of retirement benefits. A policy proposal included moving teachers to Social Security, but that would cost taxpayers more for lower benefits, according to KCEP. However, benefits must be adjusted for future employees. Specifically, as life expectancy continues to rise, it is important to adjust benefits and expected retirement ages.

Policy Recommendations and Analysis

Recommendations:

The goal of these policy proposals are to reform Kentucky's pension system by paying off the unfunded liability in order to establish a sustainable defined benefit retirement plan for our state employees that will attract and retain a talented workforce, while boosting economic activity and providing dignified retirement to our public servants.

In order to meet these goals, this proposal calls for:

- Preserving a defined benefit plan.
- Statutorily requiring the full funding of the Actuarial Required Contributions without changing the amortization period to pay off the unfunded liability.
- A one-time change in the investment target return rate to 6% and raising expected payroll growth to 1% in order to provide a more accurate ARC estimate while still being conservative in our expectations.
- Requiring the costs of future changes in benefits to be calculated and included in the ARC before going into effect.
- Amending the tax code to raise additional revenue by simplifying the filing process, eliminating some tax expenditures, expanding the base, and tightening corporate tax loopholes.
- The hiring of an independent actuary to review the ARC expectations.
- Changing the retirement age for each category of employee to reflect changes in life expectancy. This includes:
    - Increasing the minimum years of service for hazardous employees to 28 years, or to age 63 with 5 years of service.
    - Increasing non hazardous employees's requirements from a rule of 87 to a rule of 90 or 68 years of age.
    - Changing teacher's requirements to 30 years of service or age 63 with 5 years of service.
- Withholding pension benefits from teachers and non hazardous employees until age 60, and from hazardous employees until age 55, regardless of retirement status. Furthermore, employees who return to work for the state may not draw a pension while they are employed.

Benefits:

1. Efficacy:

- By fully funding the ARC every year, the unfunded liability would be paid off in 24 years, even under the current assumptions.
- There are ample options for amending the tax code that would raise significant additional revenue and contribute to paying down the unfunded liability.
    - Current Kentucky laws "allow large corporations to escape taxation through a variety of accounting strategies that small businesses can rarely use" (KCEP). This is not only detrimental to the state in the form of lost revenue that could be used to bring down the unfunded liability, but it also fosters an unfair business environment. According to KCEP, "profits sheltered from corporate taxation often go to out of state shareholders and executives, circumventing Kentucky's General Fund and its economy altogether".

2. Efficiency:

- With slight increases to the investment targets, the unfunded liability could be paid off at least four years faster than currently projected. It also places less of a strain on the employers paying into the system because their contribution rates will be slightly lowered.

3. Cost Effectiveness:

- Amending the tax code would provide significant additional revenue to pay off the unfunded liability in the following ways:
    - Simplification of the tax code
        - **$367 million**—follow surrounding states and simplify filing by shifting from itemized deductions to the existing standard deduction of $2,460 for all (ITEP and KCEP)
        - **$73 million**—simplify filing by having married couples file joint returns, which is the same filing status they do for federal income taxes and removes their ability to run each spouse's income through the entire marginal rate schedule. Very few states allow this filing status (KCEP and OBSD)
    - Reducing tax expenditures
        - **$200 million annually-**repeal the film industry tax credit program
        - **$220 million**—reduce the retirement exclusion to $35,000 (down from $41,110) and phase it out dollar for dollar (LRC and KCEP)
    - Expanding the base
        - **$115 million**—include luxury and other services such as country club and golf club membership fees, janitorial services, armored car and security, pest control services, landscaping, car washing, limousine and commercial linen services (LRC and KCEP)
    - Tighten corporate tax loopholes
        - **$66 million**—close loopholes by enacting combined reporting and throwback rule (LRC and KCEP)
    - Note: The full total economic benefits of these proposals cannot be calculated by adding up the sums of the individual proposals because of the unknown effect of how they would interact with each other to generate additional revenue. However, an approximate base expectation of **$1.041 billion** in increased revenue is sensible.

Political Feasibility

Solving a financial crisis of this magnitude requires compromise on both sides of the aisle. With $40 billion in unfunded liabilities, an increase in revenue is necessary in order to maintain services and ensure the solvency of the pension. However, changes must be made to ensure similar issues are avoided in the future. By raising the age of retirement and making changes to the ARC assessment and funding structure, this policy promotes fiscal responsibility moving forward. With these compromises, we hope to secure bipartisan support in Frankfort.