TO: College Summit on Kentucky Pensions
FROM: Hudson Chastain, Brady Crawford, Wade Lopiccolo, Hope Rowlett, Isaac Settle, Summer Taylor
SUBJECT: Kentucky Pension Reform
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Introduction

The Commonwealth of Kentucky is facing a financial crisis as its pension system continues to be underfunded year after year. The working number on how much the state owes its pension system has been $37 billion[1], but Moody's Investor Services released a report on July 2017 that increased that number to almost $70 billion in unfunded pension liabilities.[2] Overall, the state of Kentucky owes its worker's more than seven times the entire $10 billion annual state budget.[3] Studies show that Kentucky's pension system has continuously been one of the most poorly funded in the nation and it does a poor job of paying off its debt. According to a study done through the end of fiscal 2015, the median funded ratio across state plans in the U.S. was 74.6%, but for the Commonwealth, the funded ratio was only 37.4%.[4] More than 8% of the Commonwealth's population is owed money from pensions, including teachers, police, firefighters, social workers, state employees, transportation employees, mental health workers, university employees, and others who are counting on these benefits for their future financial security.[5] The following information in this document presents several actions that policymakers can take which involve a focus on three groups within the pension system: hazardous employees, non-hazardous employees, and teachers. The document discusses making changes to these employees' eligibility requirements in order to retire. These actions involve:

- Elect to change the retirement eligibility requirements and benefit factors for hazardous employees, non-hazardous employees, and teachers.
- Elect to implement a grocery tax across the state, and to legalize casinos and online gambling throughout the Commonwealth.
- Elect to mandate transparency among financial records and require a board of trustees to enforce fiduciary standards.

Background

The financial crisis that is occurring in Kentucky is one that has progressed rapidly over the recent years. A former investment committee member under Governor Steve Beshear's administration, Chris Tobe, explains that legislators are supposed to fund over $800 million into pension funds every

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[1] Loftus, Tom. "Pension costs just jumped for Kentucky school districts, local governments." Courier Journal, July 12, 2017. https://www.courier-journal.com/story/news/politics/2017/07/12/pension-costs-just-jumped-kentuckys-school-districts-local-governments/467408001/ (accessed September 24th, 2019)

[2] Moody's Investors Service, "Commonwealth of Kentucky" Update - Moody's downgrades Kentucky to Aa3; outlook stable," (accessed September 24th, 2019).

[3] William M. Landrum III, Edgar C. Ross and Donald Sweasy, "Commonwealth of Kentucky Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2015," 141 (accessed September 24th, 2019).

[4] Sussan S. Corson, "U.S. State Pensions: Weak Market Returns Will Contribute To Rise In Expense," Standards and Poor, September 12th, 2016 http://www.nasra.org/files/Topical%20Reports/Credit%20Effects/SPGlobalstates1609.pdf (accessed September 24th, 2019).

[5] "Kentucky's Pension Crisis – Frequently Asked Questions," March 8th, 2016: 1, https://kypensioncrisisdotcom.files.wordpress.com/2016/03/pension-faq.pdf, (accessed September 24th, 2019)

year. Tobe found that the state had only been funding about 60% of the target amount for the last 7 to 8 years. He raised the alarm to Governor Steve Beshear's administration in 2012.[6] While Governor Beshear noted the issue, there were no steps taken to work with legislation to find a solution. In 2015, Matt Bevin was elected as the new Governor of the Commonwealth of Kentucky, and he began to make efforts to work with legislators to find a solution. Many early proposals involved legalizing gaming throughout the state, as well as possibly legalizing recreational marijuana. Governor Bevin was quick to knock these ideas down, as he believed that either solution would bring other issues into the Commonwealth, and that they financially wouldn't work.

In 2018, Republican members of the Senate brought forth Senate Bill #1, which proposed making provisions to the retirement system by requiring that teachers hired after Jan. 1, 2019 , be placed in a hybrid cash-balance plan at the Teachers' Retirement System of Kentucky rather than the traditional business plan set in place, and it was going to reduce the 1.5% cost of living adjustments that are included in the current pension system. This bill wasn't supported by the majority of legislators and it was later declared dead.[7] In March, Senate Bill #151, which originally dealt with sewer systems, was adjusted by the Republicans in the House and presented a similar plan as Senate Bill #1. It was rushed through the House and the Senate, and Governor Matt Bevin signed the bill into law. It had the same provisions as Senate Bill #1 except that it wasn't going to lower the cost-of-living adjustments. Retirement eligibility age would increase to 65 or the "rule of 87" which requires the employees combined age and years of service be equal to 87. Teachers were outraged, as the bill was never made public before it was voted upon and legislators had little to no time to study it before voting.[8] In December of 2018, the Kentucky Supreme Court deemed the law to be unconstitutional, as it didn't meet the three-readings requirement.

Just a few short days later, Governor Bevin called for a press conference in the Capitol. He stated his displeasure for the Supreme Court's ruling, and he made the decision to use his powers to call for a special session, in the hopes that legislature could come together to find a solution. Many legislators became irate at the timing of the special session, and the move by the Governor was viewed negatively across the state. After spending hours in session, legislation was unable to make any progress. The Republicans in the House have introduced other bills that have been struck down as they continue to change or eliminate parts of the pension plan that seem controversial to other members, as well as those who are affected. In November of this year, Governor Bevin will be up for re-election as he runs against Democratic nominee and current Attorney General Andy Beshear. This election will no doubt have an effect on how the Commonwealth will go about finding a solution for the pension crisis.

Problem Definition

The health of the Commonwealth's pension system has depleted over the years for a variety of reasons. In the 1990's, the National Association of State Retirement Administrators (NASRA) adopted the annual required distribution (ARC). The ARC uses actuarial data about how many people are in the pension plan, estimates people's life expectancies and how long they will require benefits, and uses this information to help determine how much money the state needs to set aside each year to fund its pensions.[9] The NASRA stated that, "Assuming projections of actuarial experience holds true, an allocation short of the full ARC means the unfunded liability will grow and require greater contributions

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[6] Chris Tobe, phone conversation with author, Louisville, KY, July 24, 2017.

[7] A.B. #1, 2018 Senate, 2018 Reg. Session, (Commonwealth of Kentucky, 2018). https://apps.legislature.ky.gov/lrcsearch#tabs-6

[8] A.B. #151, 2018 Senate, 2018 Reg. Session, (Commonwealth of Kentucky, 2018). https://apps.legislature.ky.gov/lrcsearch#tabs-6

[9] Keith Brainard and Alex Brown, "Spotlight On: The Annual Required Contribution Experience of State Retirement Plans, FY 01 to FY 13," National Association of State Retirement Administrators, March 2015 http://www.nasra.org/files/JointPublications/NASRA_ARC_Spotlight.pdf, (accessed on September 24th, 2019).

in future years." The major issue for the Commonwealth is that for 15 of the last 22 years the government has not allocated the full ARC amount, which has caused the unfunded liability to grow vastly over the years.[10] Not funding the ARC has put the Commonwealth in a financial crisis, which raises the question: why did the Commonwealth not fully fund the ARC?

The main reason that the Commonwealth failed to fully fund the ARC is political discourse. Chris Tobe discussed that while there is a step-by-step process for the creation of the annual budget, the unofficial budget is drafted by the Governor, the Speaker of the House, and the Senate President behind closed doors.[11] Republicans have historically controlled the Senate since 2000, while the Democrats controlled the House for over 90 years until the 2016 election. The Governor's seat has flipped between the Republicans and the Democrats since 2000. Tobe expressed that since this budget is drafted behind closed doors, compromises have been made along political lines. He went on to explain that Republicans didn't want to raise taxes, and Democrats didn't want any government programs to be cut. Since the Commonwealth requires a balanced budget, the money had to come from somewhere in order to satisfy both parties. He states that this practice dates back to as early as 2002.[12]

While underfunding the ARC has been a leading cause of the pension deficit, another contributing factor is the amount of non-government participants in the state's pension plans. It is not uncommon for non-government organizations to participate in a pension plan, but Kentucky has taken that to the extreme as they have over 3,000 non-government participants. The Kentucky Chamber of Commerce reports that almost a third of the organizations that participate in the state's pension plans are non-government.[13] The issue with this situation is that some of this non-government organizations can make contributions to the pensions that consume a large portion of their revenue. One example of this was in 2014, when a non-profit called Seven Counties Service which was based in Louisville, argued that more than two-thirds of the group's gross revenue was eaten up by pension investments, and declared bankruptcy. After arguing over the outrageous amounts being contributed, a judge ruled that since the organization was a private entity, that it could leave the Commonwealth's pension system.[14] This resulted in increasing costs for public employers who don't have the ability to withdraw. The government has failed to allocate the amount of money necessary to keep its current pension promises to Kentuckians. There must be steps taken to fund the current system and prevent similar issues from arising again.

Policy Goals and Criteria

The goal of these policies is to reform the pension system in the Commonwealth of Kentucky in order to ensure that those who retire are given the benefits they were promised. This reform involves making changes in pensions for hazardous workers, non-hazardous workers, and teachers. These policies involve making adjustments to the age at which individuals can retire within these subgroups of the pension system, as well as adjusting the percentage these employees receive per year of service upon their retirement. These changes can be a stepping stone for pension reform and can help the Commonwealth protect the promises made to its workers. The legislature should consider making the following changes to retirement eligibility:

- Increase the minimum years of service for hazardous employees from 20 years to 25 years, or 63 years of age with 10 years of service, increase the currently set "rule of 87"

[10] Ryland Barton, "Kentucky's Pensions Are Worst-Funded In U.S., Study Shows."

[11] Chris Tobe, phone conversation with author, Louisville, KY, July 24, 2017.

[12] Boyd, "Chris Tobe: Pension crisis means next Ky. governor will raise taxes, cut education like never before."

[13] Chris Tobe, "Kentucky Fried Pensions," 145

[14] Mike Wynn, "Seven Counties can leave indebted Ky. pension system," Courier-Journal, May 13, 2014, http://www.courier-journal.com/story/news/politics/ky-legislature/2014/05/31/seven-counties-can-leave-indebtedky-pension-system/9806107/ (accessed September 24th, 2019)

to 90, and increase the age of eligibility from 65 years old to 68 years old for non-hazardous employees, increase the minimum years of service for teachers from 27 years to 35 years, or 60 years of age with 10 years of service.

- Implement a grocery tax of 2% on food and food ingredients that are liquid, concentrated, solid, frozen, dried, or dehydrated that are sold to be ingested or chewed by humans and are consumed for their taste or nutritional value, and implement a tax credit for those individuals in low income tax brackets.
- Implement and legalize casinos and online gambling throughout the state.
- Create fiduciary standards for the revised Board of Trustees, Office of Investments Team, and any advisory firm or third party along with minimizing the amount of third party advisors that KRS employs in an effort to lower investment expenses.

Recommendations

I. KRS/KTRS Eligibility

The first modification to retirement eligibility in these recommendations focuses on hazardous employees within the KRS system. This policy would increase the minimum years of service required for hazardous employees from 25 years to 28 years, or 63 years of age with 10 years of service. This is a 3 year increase for each scenario, which in turn means that hazardous employees will work longer before retiring, but will receive a 2.5% benefit factor. Also, by these employees working longer, they are receiving more money towards their pension. KRS will use the formula the following formula: final compensation (average of the top 3 highest salaries) x (the benefit factor) x (years of service)

Old Ex: $50,000 x 2.5% x 25 years of service=$31,250

New Ex: $50,000 x 2.5% x 28 years of service=$35,000

The second modification to retirement eligibility focuses on non-hazardous employees. This policy would increase the currently set rule of “87” to 90 for non-hazardous employees, and increase the minimum retirement age to 68 years old with 10 years of service. This is a 3 year increase for each scenario, similar to the changes made to the hazardous employees benefits. These employees will work longer, but they will also receive a 2.5% benefit factor. An example can be seen by using the same formula as before: (average of the top 3 highest salaries) x (the benefit factor) x (years of service)

Old Ex: $50,000 x 2.5% x 30 years of service (rule of “87”)=$37,500 (Age 57)

New Ex: $50,000 x 2.5% x 33 years of service (rule of “90”)=$41,250 (Age 57)

The last modification to retirement eligibility focuses on teachers in the Commonwealth. This policy would increase the minimum years of service required for teachers in KTRS from 27 years to 35 of service, or 60 years of age with 10 years of service. This is an 8 year increase from the previous system, and a 5 year increase for those who are 60 years of age. This would require teachers to work longer, but they are receiving more money towards their pensions. Teachers benefit factor would be set at 2.5% when they are eligible to retire. An example can be seen using the same formula that was used to hazardous and non-hazardous employees: (average of the top 3 highest salaries) x (the benefit factor) x (years of service)

Old Ex: $50,000 x 2.5% x 27 years of service =$33,750

New Ex: $50,000 x 2.5% x 35 years of service =$43,750

As life-expectancy in Kentucky increases, service to the Commonwealth should be extended as well. Therefore, it is critical that Kentucky public employees work longer under the proposed system. To ensure this, the penalty upon benefits will increase from 6.5% per year to 10% per year if an employee retires before a full amount of service. For example:

If a non-hazardous employee chooses to retire at 33 years of service rather than 35, the employee will incur penalty which results in a deduction of 10% per year for each year away from 35. Thus, instead of receiving 100% of their benefits, they would instead receive 80% of their benefits if they retire before a full 35 years of service.

Ex: *$50,000 x 2.5% x 33 years of service = $41,250*

$41,250 x 20% (10% for first year + 10% for second year)= $8,250.

$41, 250-$8,250=$33,000 in benefits with incurred penalty.

These three policies will make participants spend more time in the system, which in turn means that there is more money going into the Commonwealth's pension system. This will help to fund those who are currently drawing pension benefits, while also allowing those who are currently working to essentially make more when they retire. This will help give the Commonwealth time to fund those currently in the system, but it will also require the Commonwealth to pay more in the long run. To combat this potential cost, the next policy proposals focus on bringing in revenue to support the pension system.

II. Grocery Tax

While looking for a solution to the problem, Kentucky needs solutions that will steadily and quickly enact change in the deficit. This policy believes that enacting a 2% grocery tax would be beneficial for raising revenues for the state. A grocery tax, as proposed in our case, is a specific tax on food that acts as a separate entity from the sales tax to form total tax on sales of food. This tax on food and food ingredients include items that are liquid, concentrated, solid, frozen, dried, or dehydrated that are sold to be ingested or chewed by humans and are consumed for their taste or nutritional value. Kentucky would use the grocery tax as a direct funding for the pension deficit. This tax will impact more than 80% of Kentuckians with the exemptions of SNAP recipients and provide a tax credit for those household incomes under $25,750.

The average consumer expenditure on groceries is 9% or more. [15] This expenditure on the median kentucky household salary of $48,375[16] is approximately $4353.75 or more spent on groceries. The tax would take 2% out of every grocery qualifying purchase, which provides a taxed revenue of $87.075 from each qualifying household grocery purchase. Each household in the state of kentucky paying the grocery tax would provide a focused Kentucky pension revenue of $138,505,587.50. Additionally, SNAP recipients are exempt from the grocery tax and this policy also suggests a grocery 1% tax credit for people under $25,750 of their taxable income up to $257.50. These exemptions would relinquish the burden of the regressive nature of the

[15] "CONSUMER EXPENDITURES--2018." U.S. Bureau of Labor Statistics. September 10, 2019. https://www.bls.gov/news.release/cesan.nr0.htm.

[16] "Kentucky Household Income." Department of Numbers. https://www.deptofnumbers.com/income/kentucky/.

tax, while still generating stable revenue for the state. States that already use this tax and benefit from substantial revenue include California, Tennessee and more.

III. Casino and Online Gambling

A solution to the deficit problem that will generate focused Kentucky Pension revenue is to implement and legalize casinos and online gambling in Kentucky. In regards to online gambling and sportsbooks, the date of enactment would be January 1st, 2021.The following subsections will break down the regulations.

1. Mobile Gambling- Mobile gambling is defined by group access to betting platforms on either a mobile device, tablet, laptop, or desktop computer. Ex. Draftkings, Fanduel, Bovada.
2. Understanding the revenue of mobile gaming comes with understanding the features built into the location services of devices. For any user attempting to utilize mobile gambling in Kentucky, their location services must be turned on. This allows the companies providing the services such as (Draftkings or Fanduel) to locate the participant. If he or she is within the states legal territory, their money is taxable.
3. The taxable money is the handle of all finalized bets. The handle is the total amount of money wagered by the gamblers.This allows for the utility of revenue to be maximized while also treating both parties with fair taxes. The proposed tax is 8.5% of the total handle.

Standing commercial casinos and Mobile Gaming will be incentivized and regulated in the passing of the Casino and Online Gambling (Sportsbook) betting legalization. Ultimately, the state has zero risk and can generate revenue by passing legislation. Private sector gambling organizations will generate revenue focused towards generating funds to fix the deficit. Once the deficit is met, the allocation of these funds generated can be shifted to other focused organizations. The allocation will be decided by the state in a bipartisan decision.

Estimate KY Revenue

Monthly Estimates

Casino Win- $112.8 M

Online Casino Win- $20.8 M

Sports Betting Handle-$223.9 M

Sports Betting Revenue- $19.04 M

Estimated Tax Revenue For Fiscal 2021-2022 = $262.752 M

IV. Transparency of the Pension

The KRS definition of a fiduciary is extremely vague: “Of, relating to, or involving a confidence or trust as (1) held or founded in trust or confidence, (2) holding in trust, (3) depending on public confidence for value or currency".[17] Mirroring what the US Department of Labor says about fiduciary- "The primary responsibility of fiduciaries is to run the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses. Fiduciaries must act prudently and must diversify the plan's investments in order to minimize the risk of large losses. In addition, they must follow the terms of the plan documents to the extent that the plan terms are consistent with ERISA. They also must avoid conflicts of interest. In other words, they may not engage in transactions on behalf of the plan that benefit parties related to the plan, such as other fiduciaries, service providers or the plan sponsor"- the second recommendation calls for lawful standards of a fiduciary not only for the Board of Trustees and Office of Investments Team, but also for any advisory firm or third party.[18] KRS employs 118 advisors to manage the investments for the Pension.[19] A problem arises when you hire that many firms because you have repeat costs for a lot of the fees that you already paid. A lot of the fees associated with investing cover the advisor and not the fund, thus when you have that many advisors, the diversification effect is overkill and we are just losing money. The areas of the expense schedule for the pension that appear to be either redundant in fees or wildly unreasonable are investment advisory fees, performance/incentive fees, and administrative, consulting, and custodial fees.[20] The third recommendation requires the minimization of the amount of third party advisors that KRS employs in an effort to lower investment expenses. Another issue arises when examining the expense schedule because the amount of disbursement of the fees for each advising firm is unavailable. Moreover, KRS includes the amount of assets under management for each advisory firm, but does not disclose how those assets are being allocated within the firm.[21] Due to the lack of transparency KRS provides regarding investments, being clear about numbers, asset class allocation within each fund, and investment expenses are all included in the first recommendation regarding transparency and clarity.

Conclusion

Overall these policy changes will help the Commonwealth to improve the health of its pension system. These changes will be somewhat easy to implement, but will be difficult for some to accept. Changing the norm is always a difficult task, but changes must be made in order to secure pensions that current employees were promised, as well as to secure pensions for those who enter the system in the future. These recommendations coincide to create a cohesive plan that will help to improve the three areas of pitfall with the Commonwealth's pension system: funding the financial gap, modifying benefits, and ensuring accountability and transparency within the investments in the system. This wouldn't fix the state of the Commonwealth's pensions overnight, but it can be a stepping stone in the process of helping with the underfunding, poor investing, and poor structure that has occurred within the system over the years. These recommendations should be strongly considered by legislation and actions should be taken to begin reforming the Commonwealth's pension system.

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[17] https://kyret.ky.gov/Investments/Pages/Investments-Dictionary.aspx

[18] https://www.dol.gov/general/topic/retirement/fiduciaryresp

[19] https://kyret.ky.gov/Publications/Books/2018%20CAFR%20(Comprehensive%20Annual%20Financial%20Report).pdf

[20] https://kyret.ky.gov/Publications/Books/2018%20CAFR%20(Comprehensive%20Annual%20Financial%20Report).pdf

[21] https://kyret.ky.gov/Publications/Books/2018%20CAFR%20(Comprehensive%20Annual%20Financial%20Report).pdf