TO: The Kentucky State Legislature
FROM: Henry Clay College Summit on Kentucky Pensions
SUBJECT: Solving the pension crisis in Kentucky
DATE: October 18, 2019

Introduction: Kentucky has been facing a severe pension crisis for the past two decades. Due to our legislators failure to appropriate the proper funding needed to support the pension system, and after the 2010 recession when investments that the system counted on simply didn't garner a significant return, the pension system was in deeper trouble that it had ever been in before. Currently, Kentucky's public retirement plans (also known simply as KRS) are $43 billion in debt[1] and the state is in desperate need of a solution. In this proposal, we will lay out our plan to successfully restructure the Kentucky pension system, specifically the worst funded subset of the system known as the Kentucky Employment Retirement System (KERS). We have chosen to reform KERS specifically as this system has been the most neglected of all and is in the most vulnerable position regarding funding. We will present three policy proposals to reform the pension system: first, require that the state government invest the full amount specified by the actuarially determined contribution; second, encourage a switch to a 401(k) system while requiring employers to put a small percent into the pension fund; and third, implement a tax on hemp of 10%, a tax on all tobacco products of 27.5%, and increase the alcohol tax to 8% (up from current 6% sales tax) in order to raise funds for the pension system.

Background:

The issue of pension reform has been one that our legislators have not been able to tackle over the past twenty years. As a state, we find ourselves in this predicament due to both past governors and legislators failure to appropriate the necessary funds to keep the pension system viable for the number of retirees dependent on it. In a desperate attempt to find money to fund important projects including schools, public safety, and any number of other programs in the wake of the 2010 recession, the money originally designated for the pension was redirected to these projects. In addition to the lack of appropriations, the General Assembly also approved a number of benefit increases, including generous cost-of-living increases, without the ability to fund them[2].An example of attempted reform, in 2018, a bill known as SB1 was introduced to put teachers on a cash balance system like other employees. After protest, it was left alone until legislators passed it without public knowledge as SB151. The Kentucky judicial system found it unconstitutional and

1 Loftus, Tom. 2019. "Kentucky Is in a $43 Billion Pension Hole: Here Are Some Reasons." Louisville Courier Journal. https://www.courier-journal.com/story/news/politics/2018/12/17/kentucky-pension-crisis-reasons-how-we-got-here/2317233002/.

Yetter, Deborah. "Tax on E-Cigarettes Proposed to Curb the Soaring Youth Vaping in Kentucky." *The Courier-Journal*.

https://www.courier-journal.com/story/news/politics/ky-legislature/2019/07/23/kentucky-taxes-proposal-tax-vape-pens-same-cigarettes/1796932001/

2 Loftus, Tom. 2017. "Kentucky Pension Crisis: How Did We Get into Such a Big Mess?" Louisville Courier Journal.

https://www.courier-journal.com/story/news/politics/2017/08/29/kentucky-pension-crisis-how-did-we-get-into-such-big-mess/609034001/.

it was appealed. Kentucky takes 7.6% of teacher salaries to the pension project and 74% of all the money goes to paying the pension debt. Meaning 26% goes to trying to cover teacher retirement.

Problem Definition:

Throughout the country it is clear that the pension in most states remains to be an unstable practice surrounded by confusion as to its solution. Few states such as South Dakota, Tennessee, and Wisconsin have found ways to fund their pensions systems. In these states, assets cover more that 90% of their total liabilities. On the other hand, states like Kentucky are in dire need of a pension reform. In 2016, Kentucky only had 31% of the assets needed to cover its liabilities[3] related to funding the pension, earning the state the last place ranking among states for the pension funding ratio[4]. This situation leaves the question of how to fund the total liabilities of the pension.

According to PEW Research, the actuary contributions of states may be a factor of their pension success[4]. For instance, the three states that were listed above as having stable pensions have consistently invested the full amount of the actuarially determined contribution[4]. This amount not only accounts for the current year's cost, but it also factors in an amount that would be required to decrease the current unfunded liabilities of the state. Kentucky has repeatedly contributed less than the required amount, meaning that the debt only grows. With this deficit in contribution, the state is not only perpetuating its existing liabilities, but it is also contributing to further liabilities as it fails to completely cover the annual cost of pension benefits.

While this problem has been growing for a long time, it appears to have only recently gained the attention of many, which leaves all to wonder what may have spurred this newfound attention. Many would think that the political environment would be the cause, but it may be that the field of accounting largely contributed to its salience. Prior to 2015, the Governmental Accounting Standards Board (GASB) only required that pension liability only be disclosed in the notes of the government's balance sheet, a primary financial statement for evaluating the government's financial position. Because many focus primarily on the components listed on the face of this statement, it was easy to overlook this liability. Implemented in 2015, a new policy required that the government report its pension liability in addition to its discount rate, a contra-liability account, on the face of the statement. They also altered the way states reported their discount rate, or the "expected rate of return on its pension investments[5]." With the new requirement, governments with underfunded pension plans would be required to use a lower discount rate, increasing the net pension liability in the state. This disclosure requirement has

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3 "Kentucky's Successful Public Pension Reform: The Bipartisan Effort in 2013 Resulted in Fair and Effective Retirement System for Employees and Taxpayers Alike." *PEW*. https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2013/09/27/kentuckys-successful-public-pension-reform.

4 "The State Pension Funding Gap: 2017." *The Pew Charitable Trusts*, www.pewtrusts.org/en/research-and-analysis/issue-briefs/2019/06/the-state-pension-funding-gap-2017.

5 Commonwealth of Kentucky. *Pension Performance and Best Practices Analysis* . 2016, *Pension Performance and Best Practices Analysis* , Pension Performance and Best Practices Analysis .

increased transparency for constituents and has allowed them to witness the increasing funding gap over the years since 2015. Likely as a result to the new transparency, attention to this issue has grown. If more voters become aware of the growing issue, they may decide to elect new representatives who will work to undo the damage that their current representatives have created. To avoid the loss of office, many politicians have started to turn their focus to this issue[6]. They are now trying to create new policy solutions to decrease the ever-growing pension liability and increase the discount rate to decrease their net pension liability and appease their constituents.

Policy Goal and Criteria:

Our goal is to fund and restructure the Kentucky pension system. The three recommendations put forth below are only the beginning of the actions necessary to reform the pension system. While these recommendations will likely not be a final solution to this ever growing issue, they will provide a politically feasible start to addressing the issues that have plagued the pension system for the past two decades.

Our primary focus has been to remedy the absent funding for the pension system to alleviate any future deficiencies. As we look at the contributions of the state, the employer, and the consumer, we find that there are plausible alterations that can be made for each. We do not want to require one group to fund the system as we believe that a collective effort would produce a greater result. To begin, requiring the state to invest the full actuarial contribution annually can cover the annual costs and begin reducing the existing liability. Next, encouraging employees to select a defined contribution plan instead of a defined benefit plan can reduce the overall need for a pension fund. To ensure that this takes place, we propose that employers should be willing to invest more in an employee's defined contribution plan than their defined benefit plan. The result should be that more employees would select the defined contribution plan in order to receive more from their employer. Finally, in order to collect funds for the pension system, we propose a tax on hemp, e-cigarettes, and alcohol. As these products are growing in popularity among consumers, there is revenue to be made, and we would like to utilize this revenue to benefit our deserving workers.

For our proposed solutions, the political feasibility was considered. For the first proposal, we acknowledged that state officials are unlikely to be entirely pleased with the idea of allocating more money to the pension, but it is believed that they are likely to follow this requirement as the improved status of the pension can grant them favor from their constituents, making this proposal politically feasible. In regards to the taxes, the political feasibility may be slightly less favorable. Many consumers prefer that taxes are not increased, especially when it is a tax on goods that they consume. As a result of this unfavorable opinion of the tax, politicians may be hesitant to implement this tax due to fear of losing their next election. While this is a

6 Foltin, Craig, et al. "Public Pension Underfunding." *Strategic Finance*, Sept. 2018, file:///Users/jodihenon/Downloads/ACFrOgDZHS-CmL2nPRf0PJ9X0o3KKSRmSFWMW9S52clGGylLQstksjx7W24m3vR0ansBV2PfEqzAM6baPAqOCJiz5YAbV1IieslTkT7CCpWjEL2jasPvDxrc_rqcpl4=.pdf.

concern, it is believed that the benefits of the tax on the pension will outweigh the cost to the consumers. If this benefit can be demonstrated, the negative connotation of the tax can be lifted over time.

Recommendations:

(1) Require that the state government invest the full amount specified by the actuarially determined contribution

When the current condition of the Kentucky pension plan is evaluated, it is clear to see that the system has continuously been underfunded. Also, Kentucky has consistently failed to reserve a full amount of money that was determined by its own actuaries as being necessary to fund the pension system[4]. Because of this failure, the state has continued to accumulate and increase the amount of debt. They have failed to meet the amount required to cover the current year's cost of benefits and they have not decreased the pre-existing pension liability. Not only are they not meeting the existing liability cost, but that cost is also being added to the unfunded liability per year. At this current rate, the state cannot expect to see any improvement in the state of the pension system. If they can alter this path and begin to fully fund the actuary contributions, there is hope that the pension liability can be reduced and the situation can improve over time.

In order for this to occur, the state must employ trustworthy actuaries to evaluate the funding needed to cover the current year's cost of benefits and an amount that would reduce a portion of the unfunded liability. These actuaries would need to be reliable and have the skills necessary to accurately estimate this amount. After the estimate is established, the state would need its legislators to work to form a budget that includes this actuarial contribution, and they would need to stick to this budget instead of deciding to decrease the established funding.

As a means of ensuring that the full contribution is made, it could also be beneficial to alter the reporting standards for the government's financial statements. At this time, the government has the option to report the employer's actuarial contribution[4]. This allows the state to hide its own actuarial contribution from the statements. It has been seen that the requirement to disclose the full net liability for the pension has increased the actions from government officials as the current situation of the pension becomes more transparent[6]. Using the same concept, altering the reporting standards to require states to report their actuarially determined contribution on the face of their financial statements could have the same impact. If constituents observe how little the state is actually contributing, they could grow displeased with their representatives and threaten to remove them from office during the next election. To avoid this outcome, the politicians can improve the contribution to cover the total amount and increase the favor of their constituents. This offers a way to reiterate the requirement to further pressure the state to maintain its contributions.

(2) Taxes

We are in need of funding for the pension system. Instead of raising taxes for the entire state of Kentucky, it is much more beneficial to tax new commodities. The rise of the hemp industry in Kentucky has opened the door for a new revenue source through which we can fund the desperately underfunded pension. While we cannot tax hemp that is purchased with a medical prescription, we can tax this popular commodity that many are purchasing for any number of other reasons or uses.

Many have put forth plans that raise funding through a variety of other means including the legalization of recreational marijuana and casino gambling. While these options may seem attractive on the face, the long term impact of such decisions would alter the very fabric of Kentucky society, something that many Kentuckians adamantly disagree with. In terms of casino gambling, Governor Matt Bevin has pointed to suicide as a societal cost that would come with its implementation. In his view, the revenue generated through casino gambling would not be an adequate solution to fund the failing pension[7]. In regards to the legalization of recreational marijuana, many Kentuckians do not support such an initiative. According to the Kentucky Health Issues Poll conducted by the Foundation for a Healthy Kentucky, 69% of respondents oppose the legalization of marijuana for recreational purposes while 78% favor the legalization of marijuana for medical purposes if recommended by a doctor[8]. If recreational marijuana is something that future Kentuckians support, that can be discussed at a later date, however, being that support is overwhelming for medical marijuana, we should take advantage of this support through taxing hemp.

The Courier Journal reported that the state's gross product sales of hemp in 2018 was $57.75 million and as this number continues to grow each year, a tax on the sales of this product would generate sizable revenue that could be applied to the pension fund[9]. This tax would be 10% on all hemp products with the exclusion of hemp products purchased with a medical prescription. Based on 2018 gross product sales, this tax would generate $5,775,000 in revenue that could be directed to the pension system. Another source of revenue will be raised through equaling the tax of tobacco products with a tax on E-cigarettes. Currently, the tax on regular cigarettes is $1.10 per pack. This tax would be 27.5% on the wholesale product which would result in $35,000,000 in increased revenue. The last tax we are going to implement is an 8% tax on alcohol. Currently, alcohol is only taxed through Kentucky's 6% sales tax, but this 2% increase would result in a $195,643,000 increase in revenue[10].

(3) Tier 4 pension program

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7 "Matt Bevin Points to Suicides as a Reason to Oppose Gambling." 2019. https://www.courier-journal.com/story/news/politics/2019/07/31/matt-bevin-says-suicides-reason-oppose-gambling-kentucky/1876509001/.

8 "Kentuckians' Views on Marijuana Laws and Use." 2012. *Foundation for a Healthy Kentucky: Kentucky Health Issues Poll*.

9 Bruce Schreiner. 2019. "Hemp Is Growing like Crazy in Kentucky. Just Look at Last Year's Sales." *Louisville Courier Journal*. https://www.courier-journal.com/story/news/2019/03/18/kentucky-hemp-sales-surged-2018-ryan-quarles-says/3201995002/.

10 Budget of the Commonwealth: Budget in Brief

We are going to create a tier 4 retirement system in which a 401(k) is encouraged while still giving the new employee an option to join the pension program. In this new system, there will also be an increase in the years of service required in order for retirement to occur. This will be raised from 27 to 30 years of service before they are able to retire with no set retirement age. In terms of money for this system, every percent that the employer matches in a 401(k) program, a quarter of a percent will be contributed to the pension program. If the employee chooses to enroll in the pension program, the employer will match a half percent of what it would contribute to a defined benefit plan for the employee's pension program.

The goal of this proposal is to allow the employee to have the opportunity to determine his/her own retirement plan. It is often unpopular among constituents to be instructed by the government on how they are to acquire their earned benefits. In order to alleviate this animosity, this recommendation seeks to discretely encourage the employee to choose the 401(k) option in the new system. The incentive to seek the plan with the greatest employer contribution will direct employees to the defined benefit plan and phase out the pension over time. This increases the political feasibility of this shift in tiers as constituents are more likely to feel as though the government is not dictating their actions.

Conclusion:

As we are all aware, Kentucky is in need of a solution to this severe pension crisis. While many have proposed solutions to the problem, none have proved to be effective or feasible. As a means of remedying this problem, we have seeked to provide sufficient funds to the pension system in order to sustain it over time or until the pension is no longer in existence. In order to create this funding, we have proposed contributions through different methods from the state, the employer, and the employee or consumer. These contributions from each group can help Kentucky relieve its current liability and create funds for the future.

By requiring that the state government invest the full amount of the actuarially determined contribution, encouraging new employees to use the 401(k) method while requiring employers to put a percent into the pension fund, and implementing taxes on multiple new commodities to raise money to successfully fund the pension system, we will be able to begin the process of solving this long lasting problem. It is our goal that these solutions will provide lasting relief to our state and its citizens. So many individuals rely on the pension to sustain their way of life after retirement, and we hope that they can collect the benefits that they have earned as a result of the implementation of these proposed solutions. We greatly look forward to discussing this issue further. Please contact us if you have any questions.