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Rhode Island Pension Reform: Implications and Opportunities for Education

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On August 24, 2010, the state of Rhode Island received some outstanding news. Its yearlong, bipartisan effort to develop new policies to spur educational improvement was about to pay off. The state, along with eight others and the District of Columbia, was named a winner of the U.S. Department of Education's Race to the Top grant competition.[1] The reward: $75 million in new education funds, the largest single competitive federal grant ever to flow to the tiny coastal state.[2]

But while state leaders celebrated their hard-won victory, a growing, and mostly hidden, financial hole was already sucking away the entire award and more. The state's required pension contributions, the second-fastest growing line-item in its budget, had doubled from 2003 to 2010, from $139 million to $302 million. And by 2013, when the federal funds are supposed to be hard at work transforming the state's schools, required pension contributions are expected to double again, to $615 million.[3] The numbers are staggering: the Pew Center on the States puts Rhode Island's unfunded pension liability at $4,479 for each of the state's residents.[4] And State Treasurer Gina Raimondo has cited more recent estimates of twice that much.[5]

These alarming statistics have led to an unprecedented effort to reform the state's pension plan. Confronting this fiscal nightmare is the right thing to do. Not only is the current system a financial back-breaker, it can also work to prevent the state from recruiting, retaining, and adequately compensating the high-quality teachers and principals that are critical to its educational and economic success. The current pension system is far from equitable: it highly rewards some teachers, penalizes others, and pushes some good teachers into premature retirement. It also allows teachers with similar years of experience to receive vastly different benefits. These facts, along with the budget crisis, should be more than enough to galvanize state leaders. Right now, they have an opportunity to solve a financial crisis in a way that also advances the state's ambitious, and essential, educational goals.

This brief answers the following key questions about Rhode Island's pension system and possible reforms:

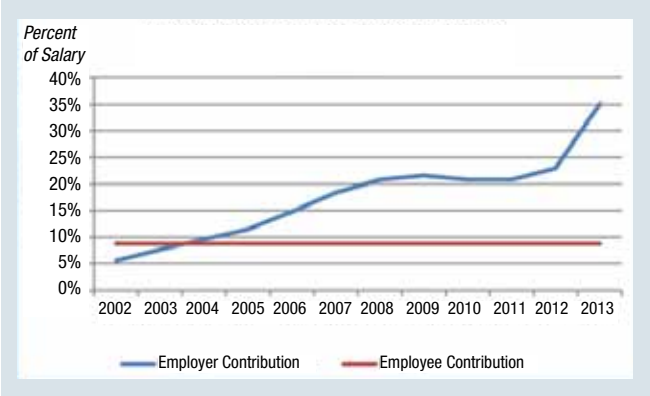
1. Why is pension reform urgent?
2. What caused the pension crisis?
3. How does Rhode Island's pension system work?
4. How does the current system treat similar teachers differently?
5. What is the current reform proposal?
6. What are the legal implications of pension reform?
7. What should policymakers do?

Why Is Pension Reform Urgent?

Rhode Island's pension crisis is also an education crisis. If the state does not act to rein in pension costs, it will be required to contribute an increasing amount each year to meet pension obligations. If this happens, the pension system will siphon money that might otherwise go to higher wages for teachers, better professional development for these teachers, or extended learning opportunities for students. Teacher layoffs could also result.

The threat grows daily. Rhode Island's pension system is a defined benefit plan, which means employees receive a set annual pension amount, no matter how long they live or how well (or poorly) the pension system's investments perform. Since employee contributions are fixed, the state must make up the difference if employee contributions and investment

Figure 1. Comparison of State Employee and Taxpayer Contribution Levels Over Time



Source: Gina M. Raimondo, *Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System,* June 2011.

returns fall short of obligations.[6] Over the past decade, as shortfalls have grown, the state has had to increase its contribution. The total state contribution for state employees and teachers has grown steadily from 5.6 percent of salary in 2002 to approximately 23 percent of salary in 2011, and it is projected to grow to 35 percent of each employee's salary in 2013.[7] (See Figure 1.)

What Caused the Pension Crisis?

Poor investment returns, caused by the recent financial crisis and continuing economic slump, are partly responsible for Rhode Island's pension problems. But the roots of the crisis go back decades. State Treasurer Raimondo has outlined five causes:[8]

- *Use of unsound actuarial practices*

Over decades, the state made a number of poor long-term decisions, such as changing its accounting method during the 1990s technology bubble to allow it to reduce contributions at the time.

- *Increasing benefits without ensuring there was money to pay for the increases*

Throughout the 1960s, 1970s, and 1980s, the state increased public employee benefits—many times retroactively—without requiring corresponding increases in contributions from employees or the state.

- *A flawed pension plan design*

The set-up of the current plan has led to an imbalance in its so-called "normal cost," meaning the amount that must be paid in any given year, either by employees or by the state, to fund the benefits earned during that year. Because the normal cost was never paid for many retirees, shortfalls built up over time.

- *Retirees who live longer*

Increases in current and projected life expectancy mean that more money will be needed to provide promised benefits and increases to reflect the cost of living.

- *Lower-than-assumed investment returns*

The state assumed annual average investment returns of 8.25 percent, but over the last decade, returns have averaged only 2.28 percent.

ERS by the Numbers*

Total pension liability: According to the Pew Center on the States, Rhode Island currently owes $11,500,425 in pension benefits to current employees and retirees. Of that amount, only 59% is funded.** More recent estimates from the State Treasurer's office report that only 48.4% of the liability is funded, for a total unfunded liability of $6.8 billion.***

Teacher contribution: 9.5% of salary, excluding overtime

Employer contribution: varies based on ERSRI's liability; about 23% of salary in 2011****

Vesting period: 10 years

Retirement eligibility age: age 62 for employees hired before July 1995 and those with at least 29 years of service; age 65 for the rest

Cost-of-living adjustment: varies; maximum is 3%

* Employees' Retirement System of Rhode Island Handbook, unless otherwise cited

** Pew Center on the States, "The Trillion Dollar Gap Grows Wider," April 25, 2011. Available at: http://www.pewcenteronthestates.org/initiatives_detail.aspx?initiativeID=85899358839.

*** State of Rhode Island, Office of the General Treasurer, "By the Numbers," November 3, 2011. Available at http://www.treasury.ri.gov/secure-path-ri/bythenumbers.php.

**** Gina M. Raimondo, *Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System*

How Does Rhode Island's Pension System Work?

Pension systems are, to put it mildly, complicated. And Rhode Island's plan for funding the retirements of its public employees—teachers, state employees, and some municipal employees—is no exception. But understanding key elements of the Employees' Retirement System of Rhode Island (ERS), as the current system is known, is an essential first step in addressing its problems.

ERS is a *defined benefit* plan, which means the employer—in this case the state—provides the employee a certain regular payment during the entire length of his retirement years. To fund this pension, teachers must regularly contribute 9.5 percent of their salary, excluding overtime.[9] The state kicks in a contribution as well, an amount that is set each year by an actuary, depending on the plan's projected liabilities.[10] All these funds are invested, but if the returns fail to generate enough income to meet projections of what will be needed to pay out these pensions, the state must make up the difference. Defined benefit plans are safe bets and often good deals for employees. The risks are borne by employers, which is why most private sector employers have switched to something called a *defined contribution* plan.

Under a *defined contribution* plan, such as a 401(k), the benefit varies and the contribution, usually a contribution from the employee and often matched by the employer, is fixed. Unlike with defined benefit plans, there is no guaranteed pension payment; the risk falls onto the employee, and the amount of her retirement savings depends on how her investments perform.

In Rhode Island, a formula determines the amount of the pension benefit that an ERS participant earns. (See Sidebar, "Pension Benefit Formula.") The formula accounts for the salary an employee earned in his highest-earning years and the number of years he worked in that position. This figure is multiplied by something called a "service credit rate," essentially the amount of pension benefits that an employee earns each year. In the current plan, this rate increases the longer the employee has been on the job. As of 2009, the state implemented a two-tiered service credit rate, meaning that teachers earn different amounts based on when they joined the pension system and when they became eligible to retire.

Teachers "vest," meaning they qualify for pension benefits, after 10 years of service. Most teachers hired before July 1995 receive full benefits at age 62. Those hired after July 1995 are eligible for benefits beginning at age 62 if they have at least 29 years of service; otherwise they are eligible to receive benefits at age 65. Teachers who retire earlier may choose to receive reduced benefits. Or, they can wait until age 65 and draw benefits.[11]

Three years into retirement, teachers begin to see an increase in their monthly checks in the form of an annual cost-of-living adjustment, or COLA. These adjustments vary depending on when a retiree entered

Pension Benefit Formula

Annual benefit = (final average salary) x (years of creditable service) x (service credit rate)

- **Final average salary** = the average of a teacher's three highest consecutive years for those eligible to retire before September 30, 2009; average of a teacher's five highest consecutive years for those eligible to retire after that date.
- **Years of creditable service** = teachers receive a year of retirement credit for each school year in which they contribute and are employed at least 135 full days. A teacher may be eligible to purchase service credits for periods of official leave or other types of employment.
- **Service credit rate** = ranges from 1.6% for the first 10 years of service to 3.0% for some mid-to-later years. These rates vary by teacher based on when he vested and whether he was eligible to retire on or before September 30, 2009.

Certain Older Employees/Retirees		More Recently Hired Employees/Retirees	
Years 1-10	1.7%	Years 1-10	1.6%
Years 11-20	1.9%	Years 11-20	1.8%
Years 21-34	3.0%	Years 21-25	2.0%
Year 35	2.0%	Years 26-30	2.25%
		Years 31-37	2.5%
		Year 38	2.25%

Source: Employees' Retirement System of Rhode Island Handbook

the system: the increases for some are 3 percent compounded annually; for others, who retire later, they are 3 percent or the increase in the Consumer Price Index (CPI), whichever is less. For employees eligible to retire after June 2010, the COLA is also either 3 percent or the CPI increase, but it applies to only the first $35,000 of benefits, indexed annually.

How Does the Current System Treat Similar Teachers Differently?

Pensions are an important component of teacher compensation. And while the current debate focuses, appropriately, on the financial toll on the state, it sometimes fails to fully account for how this compensation directly impacts the teacher workforce.

Often, battles around teacher compensation and benefits pit brand new teachers against veterans—those who have taught for more than five years. But, in Rhode Island, there are also significant disparities among different groups of veteran teachers. Benefits are heavily back-loaded toward the most veteran of teachers—those with 25 years or more of experience.

Although research shows that teachers' effectiveness increases quickly in their first few years, it also shows little difference in effectiveness between a teacher with five years of experience and one with 30.[12] Yet Rhode Island's current pension system doesn't reflect this fact; it doesn't even allow teachers to vest—to become entitled to a retirement benefit—until they have taught for 10 years. For a teacher who passes that threshold, the 12th year of teaching earns a lower service credit rate than the 22nd, which in turn earns less than the 26th. (See Sidebar, "Pension Benefit Formula.")

This seniority-based retirement system combines with a seniority-based system for salary and other benefits to create a situation in which the most senior teachers are compensated in ways that have little or no relation to their abilities or responsibilities. Moreover, professionals from other fields who are new to teaching might never catch up, and teachers who move to different states are penalized.

Rhode Island's pension system discriminates on the basis of age; it arbitrarily rewards certain ages and years of service over others. This design often penalizes not just younger teachers, but also those who wish to teach past a traditional retirement age. In fact, the Federal Reserve's New England Public Policy Center notes that many such systems "encourage people to exit the labor force for the last 20 or more years of life."[13] Along with pushing some teachers out too early, systems that favor a particular retirement age also force others to stay too long. In a nationwide survey by Education Sector in 2008, nearly four out of five teachers agreed with the statement that "too many veteran teachers who are burned-out stay because they do not want to walk away from the benefits and service time they have accrued." But about the same number indicated that making it

Table 1. Fictional Teacher Attributes

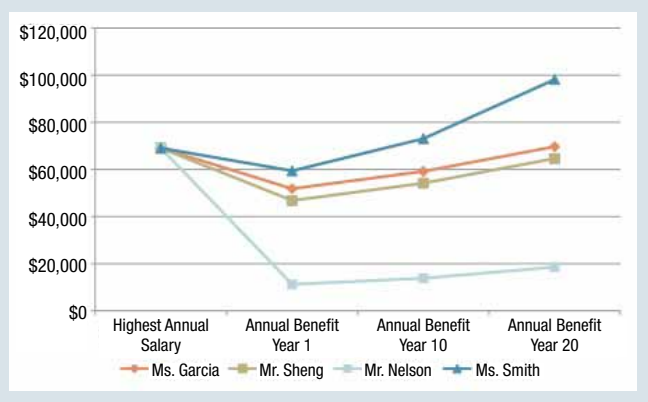
Name	Current Age	Age When Hired	Years Taught (June 2011)	Notes	Age at Retirement	Years Taught at Retirement
Ms. Garcia	32	27	5 years	Not yet vested in the retirement plan	65	38 years
Mr. Sheng	45	30	15 years	Taught for 5 years in another state with a 10-year vesting requirement, so lost any benefits accrued from the other state	65	35 years
Mr. Nelson	64	54	10 years	Before teaching, worked as a scientist for 30 years	65	11 years
Ms. Smith	65	27	38 years	Retired in 2011; eligible to retire at 55, but enjoyed teaching so much, she stayed on for an extra 10 years, even though doing so caused her to lose some of her lifetime pension benefits	65	38 years

easier to leave and return to teaching, without risking the loss of retirement benefits, would help school districts attract and retain high-quality teachers.[14]

Consider four teachers who began teaching in Rhode Island in different years. (See Table 1 and Figure 2.) Assuming salaries are only increased to adjust for inflation and the structure of the salary scale doesn't change otherwise over the next 35 years, all four teachers will end their careers with the same salary (approximately $69,000 in 2011 dollars), since the salary schedule in Providence maxes out after 10 years. But they will have vastly different pension benefits.

- Both Ms. Garcia and Ms. Smith started teaching in Providence at age 27, and each taught for 38 years. However, Ms. Garcia entered the system much later than Ms. Smith—she was hired in 2006, while Mrs. Smith was hired in 1973—so her service credit rates are lower and her COLA only applies to the first $35,000 of her annual benefit. The difference in COLAs is what accounts for the growing gap between Ms. Garcia's and Ms. Smith's benefits: initially, Ms. Smith receives about $7,500 (or 15 percent) more than Ms. Garcia. By year 20 of retirement, the difference is $28,500 (Ms. Smith's benefit at this point is about 40 percent more than Ms. Garcia's).
- When you count his service out of state, Mr. Sheng taught for a longer period of time than both Ms. Garcia and Ms. Smith, yet his benefit is lower than both of theirs. The annual benefit for Ms. Garcia, the teacher to whom Mr. Sheng is most similar, is about $5,000 more. Mr. Sheng's benefit, like Ms. Garcia's, also increases at a slower rate than Ms. Smith's since he entered the system at a later point.
- Because Ms. Smith was fully vested before 2005, she is in a different category than the other teachers. She has higher service credit rates and a more favorable COLA arrangement. As a result, her annual benefit is much higher, especially as she gets older and the COLA compounds.
- Mr. Nelson taught for much less time than the other teachers, so naturally his benefit is quite a bit lower. But had he retired two years earlier—at age 63, after nine years of teaching—he would not have received a pension.

Figure 2. Highest Salary and Retirement Benefits Over Time for Fictional Teachers (in 2011 Dollars)



Note: Authors' calculations. Salaries are based on Providence's 2010-11 basic salary scale. Assumes that salaries are only increased to adjust for inflation over the next 35 years, and that all retirees live to at least age 85 (year 20 of retirement). Assumes 3 percent annual COLA for all teachers, including those that would otherwise have a COLA equal to the increase in the Consumer Price Index, if it were less than 3 percent. Note that this graph compares benefits at different points in time (e.g., year 20 of retirement for Ms. Garcia is 2066, and it is 2031 for Ms. Smith), although all numbers are reported in 2011 dollars. This enables us to compare teachers who have similar experience but who entered this system at different times, thus are treated differently under recent reforms.

What Is the Current Reform Proposal?

The Rhode Island Retirement Security Act of 2011 (RIRSA), the new system proposed by Governor Lincoln Chafee and Treasurer Raimondo, aims to be affordable and sustainable for the state while providing a fair and secure retirement for public employees. Under the proposal, all employees would make a transition to a hybrid plan—part defined contribution, part defined benefit—in which the employer and employee would share market risk. Teachers would contribute 8.75 percent (.75 less than what they now pay) out of their paycheck toward their retirement. Out of that 8.75 percent, they would contribute 3.75 percent toward a defined benefit—for which the vesting period would be reduced from 10 years to five years—and 5 percent to a personal retirement account. The state would contribute an additional 1 percent to this account. Unlike the current pension system, the proposed hybrid plan has a portable component—employees can take the funds elsewhere if they move out of state.

RIRSA also changes the retirement age for employees not currently eligible for retirement. If an employee is 52 years old, is vested, and can currently retire before age 62, her new retirement age is 62. For all other employees, the retirement age is the same as it is for Social Security, typically 67.

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One of the most expensive parts of the current pension system is the COLA. The proposal now being considered suspends the COLA until the pension system reaches an acceptable funding level. When the system reaches 70 percent funding, the state would bring back reduced COLAs for pensions under $20,000. When the system reaches 80 percent funding, COLAs would be restored for all pensions.

Savings from a COLA freeze would not accumulate for many years. But since the state's contribution rate must be set annually, the proposal also must address near-term spikes in required pension payments. The proposal also recommends that the unfunded liabilities be re-amortized. Just as a 30-year mortgage spreads payments over time, the re-amortization would stretch Rhode Island's payments from 19 to 25 years. This extension would reduce the annual payment, but the total payment would take longer to pay off. To safeguard the future health of the system, RIRSA also calls for protective measures such as requiring fiduciary training for members of the board that manages it.

How Might the Current Plan Impact Our Fictional Teachers?

COLA Reform

Since Ms. Smith and Mr. Nelson are retiring in the next year or two, their benefits would be frozen. Education Sector projects that inflation will erode the value of Ms. Smith's annual benefit of $59,395, making her pension feel more like $43,000 in 10 years' time. In 19 years, when the COLA freeze is projected to lift, her pension's purchasing power will drop such that her annual benefit is worth about $33,300 in 2011 dollars.[15]

As for Mr. Nelson, his annual benefit is $11,212, so his COLA is projected to be frozen for 13 years. Before the COLA kicks in, however, his purchasing power will drop to about $7,600 13 years from now. Since Mr. Nelson worked as a scientist for the 30 years prior to becoming a teacher, he has another retirement account. His other retirement account, which is a defined-contribution account, is healthy enough that he can make do with his pension benefit's decrease in value.

Hybrid Plan

The proposed hybrid plan will start in 2012, so Ms. Garcia and Mr. Sheng will be affected by this portion of the reform plan. How both teachers fare under the new plan depends on a variety of factors: how they invest the funds in their personal retirement account, how the market performs in the coming years, how much they decide to withdraw from the 401(k) account each year during retirement, and how long they live. A few things are clear, however. Teachers will keep any benefits they earned under the old system prior to June 2012. Also, the vesting period for new teachers will be cut in half, from 10 to five years. This reduced vesting period, combined with the defined contribution component of the plan, ensures more equitable treatment for teachers who switch jobs or, for example, need to move from the state because of family circumstances. Finally, teachers will not be able to access the defined benefit component of their pension until age 67, rather than at age 65 under current law.

Both teachers could benefit from the new plan—or not. In particular, since Ms. Garcia is just beginning her career, investments made early may grow handsomely over a 34-year period. For example, if Ms. Garcia lives to age 83—the average life expectancy for someone with her characteristics—she might have a much higher yearly retirement income than under the current plan. However, there's the chance that she could make poor investment

decisions or the market could perform poorly. Or, she could live past 100 and watch the defined contribution run out, leaving her with only the defined benefit portion of her pension.

What Are the Legal Implications of Pension Reform?

Pension reform is more than just an educational, financial, and political issue. It's also a legal issue. State pensions are protected under Rhode Island law. And legal constraints are one of the key reasons why the state's past efforts at pension reform have largely ignored retirees.

This time, though, the magnitude of the problem makes a solution unlikely unless the state can address its obligations to current retirees. In particular, it is likely that the freeze on COLA benefits proposed in the legislation will be contested in court. And it's clear that the bill's sponsors have anticipated these challenges.

Overview of Rhode Island Legal Protections

In Rhode Island, courts have adopted what they call a "mixed" approach to the protection of public employee pensions. The courts have clearly held that a pension is more than a "gratuity" that can be amended or withdrawn at any time. However, they have been hesitant to define exactly what protection is given. While Rhode Island has significant freedom to make prospective changes to the pension benefits to be earned by current employees, other types of changes involve greater legal risk. Given the lack of definitive precedent in Rhode Island, it is difficult to quantify the extent of that risk.

COLAs

It appears that reducing the COLAs payable to current retirees would be impermissible. The Rhode Island Supreme Court has ruled that individuals who retire while a COLA provision is in effect are entitled to that COLA for the duration of their retirement, and that such adjustments cannot be reduced or eliminated. It is important to note, however, that it is possible for the state to exercise its police power to reduce COLAs where such reductions are reasonable and necessary to achieve an important public purpose (see below).

It is possible that the state would be permitted to reduce or eliminate COLAs for individuals not yet retired, although no Rhode Island courts have ruled on the issue. In the current litigation, the court implied that COLAs for vested, but not yet retired, individuals are protected on the same basis as they are for the base retirement benefit, and therefore COLAs could not be retroactively changed except under a valid exercise of the state's police power.

Past Benefits

Assume an employee had worked for the state of Rhode Island for 10 years and had accrued pension benefits at the rate of 2.5 percent of salary per year. Could the state pass a law retroactively lowering that benefit to 2 percent of salary per year?

The magnitude of the problem makes a solution unlikely unless the state can address its obligations to current retirees.

Courts in Rhode Island have never directly considered the issue. However, it is highly likely based on the reasoning in other cases that if the employee is vested no retroactive changes would be permitted. The lower court, in the currently pending litigation, has agreed with this analysis.

If, however, the employee is not vested, retroactive changes to the unvested benefit are likely to be permissible. Again, because Rhode Island courts have never directly ruled on the issue it is difficult to predict. In one case, Rhode Island was permitted to make a retroactive change prior to the time an employee's benefit vested, but the change was to the eligibility provisions for disability retirement, not to the regular retirement provisions. It is unclear whether a retroactive change to the accrual rate described above would be treated by a court in the same manner as a change to disability pension eligibility that applied to individuals who had not yet become disabled.

Future Benefits

Take our example of an employee who has worked for the state for 10 years, and who during that time has accrued a pension benefit equal to 2.5 percent of salary per year. Could the state prospectively change the retirement formula by lowering it to 2 percent of salary for years of service not yet performed?

No Rhode Island decisions are directly on point, but the reasoning in other pension cases in Rhode Island suggests that such changes would indeed be permissible, even for vested participants. The Rhode Island Supreme Court has, for example, acknowledged that a government has "broad discretion to prospectively change the pension benefit plan for [participants] who have not yet retired." However, this statement was made in a case where prospective pension benefit changes were not directly at issue. As a result, the statement would not necessarily bind a future court directly considering the issue of prospective pension benefit changes.

The Exception: Police Power

A state's "police power" refers to its power as a sovereign to act to protect the health, safety, and welfare of its citizens. Even where the state is bound by a contract, as in the case of COLAs for Rhode Island's current retirees, it always retains its police power.

It is important to keep in mind that there is no objective test that is used to determine whether a state may validly exercise its police power.

However, where a state seeks to rely on its police power to substantially impair a contract to which it is a party, the United States Supreme Court has held that the court must establish that the impairment is reasonable and necessary to serve an important public purpose, "such as the remedying of a broad and general social or economic problem."

To show that a change is necessary, the state must establish:

- That no less drastic modification could have been implemented to accomplish the state's goal; and
- That the state could not have achieved its public policy goal without modification.

There are very few cases addressing detrimental changes to public employee pensions where the court has found a substantial change to be a valid exercise of a state's police power. In a recent case in Minnesota, the court held that the state was permitted to temporarily reduce the COLA for public employee pensions as part of a broad plan to address plan underfunding pursuant to its police power. In upholding the COLA reduction, the court noted that all interested parties (current employees, retirees, the state, and the taxpayers) were sharing in the burden associated with remedying the plan's underfunding, and that the court was hesitant to interfere with the apparently reasonable legislative judgment regarding the preferred method for addressing such underfunding. The court rejected the argument that the state needed to pursue other remedies, such as raising taxes, before reducing retirees' COLAs.

The proposed pension reform legislation in Rhode Island has much in common with the Minnesota case: it declares that the state's pension system has reached an "emergency state," proposes a temporary adjustment, and seeks to share the burden across current employees, retirees, and taxpayers.

It is important to keep in mind, however, that there is no objective test that is used to determine whether a state may validly exercise its police power. Rather, it is always a fact-intensive, case-by-case inquiry.

What Should Policymakers Do?

Pension reform is difficult, but necessary. The state must proceed cautiously to balance its legal and ethical obligations, not only to retirees and taxpayers, but also to current and future employees. Policymakers working to correct the plan's financial deficiencies must consider how components of the plan can help the state attract and retain excellent teachers.

1. Tie benefits to contributions

Over the long term, a pension system is sustainable only if the total contributions made by and for employees, along with investment gains, equal the benefits that employees receive. Rhode Island's experience shows that if these contributions and benefits are not aligned, the state will eventually confront a large deficit.

Although a defined benefit system, in which benefits are based on average salary and years of service, has many advantages, it also creates imbalances. On the one hand, it offers security to employees because the benefits remain the same or increase every year no matter how long a retiree lives. On the other, it presents risks to the state: policymakers are tempted to offer more benefits that are paid for with future dollars, but they usually don't provide assurances that funds will be there to meet future obligations.

Another major problem with many defined benefit plans is that, in some ways, they function like a lottery, disproportionately rewarding some teachers over others. Teachers who stay in one district or state for their entire careers are generally well-served because their benefits are much greater than the contributions made on their behalf. But those who teach for less than 15 years or so, or who come from other careers, or move in from another state, may receive far less than what is contributed on their behalf. This design is not only inequitable, it distorts the decisions that teachers make about how long, where, and even whether to teach.

One possible solution is a defined contribution plan, such as the 401(k) plans popular in the private sector. There are significant advantages to these plans because they are portable and age-neutral. They let employees take their savings from one employer to another, and they do not create big incentives to retire at a set age (or to work longer just to get benefits). The downside is that employees tend to save too little under 401(k) plans and, most important, they bear the entire investment risk. These plans often lead to less secure retirements; as the last five years demonstrates, even prudent savers can see their retirement funds disappear in a down market. Just as states were tempted to increase benefits in more prosperous times, they must conscientiously avoid rash moves in the other direction.

Hybrid plans, such as cash balance plans, have many of the advantages of defined contribution and defined benefit plans. Like a 401(k), a cash balance plan is portable and age-neutral, meaning that it does not discriminate based on a person's age. But like a defined benefit plan, it offers stable returns, thus providing greater retirement security. Cash balance plans also reap the financial advantages of group investing. With group investing, investment managers do not have to account for lifecycle considerations—older investors can't take the risks that young investors can—that can reduce returns. Most important, these plans honor the fundamental tenet of pension sustainability: they align contributions with benefits.

Rhode Island's pension crisis is the fruit of many decades. The responsibility for fixing it should also be shared across many decades.

The Rhode Island Retirement Security Act of 2011 goes a long way toward tying benefits to contributions. The bulk of this hybrid system, the defined contribution plan, is both portable and age-neutral and moderates the employee's risk by including a defined benefit. It also reduces the vesting period from 10 to five years, making the plan more attractive to a mobile workforce. Finally, by applying an equal service credit rate across all years of service, the new plan ensures that pension benefits accrue equitably to all of the state's 13,000-plus current teachers.

2. Share the burden

Rhode Island's pension crisis is the fruit of many decades. The responsibility for fixing it should also be shared across many decades.

Other states have tried to address pension shortfalls by slashing the pensions of new teachers and using the contributions of these teachers to subsidize current teachers and retirees. In Illinois, for example, the Legislature recently divided the state's teachers

into teachers hired before January 1, 2011, and those hired after. Tier 2 teachers pay at the same level of contribution—9.4 percent—as Tier 1 teachers, but they have significantly reduced pension benefits. According to pension experts Robert Costrell and Michael Podgursky, a new 25-year-old teacher in Illinois will not break even on her contributions until she is 51 years old and has taught for 26 years. If that same teacher decides to stop teaching in her 30s or 40s, she will not receive any employer contributions at all. Under this system, new teachers, mobile teachers, and career-changers all relinquish significant pension wealth.[16]

Saving the pension system entirely on the backs of new teachers will not only fail to solve the state's financial problems; more important, it will rob its future by making it more difficult to recruit new teachers. Instead of following the example of Illinois, states should require all stakeholders—new teachers, current teachers, retirees, and taxpayers—to share the pension burden. The final stakeholder group, taxpayers, is often omitted in discussions of burden-sharing. Yet taxpayers, too, have a responsibility for a state's obligations. Thus increasing revenue should be an option.

The Rhode Island proposal mostly succeeds in sharing the burden. Current teachers take on more risk. Taxpayers, although they pay less annually, pay over an extended term. They do not, however, contribute through increased tax rates.[17] Retirees bear the greatest load of all: as the years pass without a COLA, those with small pensions will see their buying power decrease. A more equitable plan would reintroduce COLAs more quickly for retirees with the smallest pensions. That would ensure that Rhode Island does not fix its finances by impoverishing its retirees.

3. Prevent this from happening again

In flush times, legislators and governors often increase pension benefits to public workers. But they are generally not around when the bill comes due years later. While state constitutions and court rulings offer many pension protections for workers, there are fewer safeguards to prevent states from taking on excessive obligations.

Addressing this problem, Georgia and Oklahoma have passed constitutional amendments requiring legislators to pause between making a proposal to increase benefits and voting on that proposal. If the proposal seeks to change the benefit calculation, legislators must prepare a full report showing how they plan to pay for it.[18]

Although the Rhode Island Retirement Security Act of 2011 does not propose an amendment, it does include several provisions that protect pension benefits while ensuring transparency and accountability. First, if the Retirement Board acts against the advice of the state's actuary, state officials must be notified. Second, the proposal triggers an alert if the plan reaches "endangered" status—if the funding level is 50 percent or less or if the level has decreased for the past five years. In that case, the Retirement Board notifies the Legislature and various state officials and implements an emergency strategy to address the problem.

Teachers, likewise, deserve clear and accessible information about their pensions. They need to know the amount they have contributed, what has been contributed on their behalf, and their expected retirement earnings.[19] This type of information, familiar to 401(k) participants, is not necessarily available to participants in defined benefit plans. Finally, if the state offers disproportionate benefits to a small group of teachers, the gap between contributions for individual teachers and their accrued pension wealth should be transparent to all.

Notes

1. U.S. Department of Education, "Nine States and the District of Columbia Win Second Round Race to the Top Grants," August 24, 2010. Available online at: http://www.ed.gov/news/press-releases/nine-states-and-district-columbia-win-second-round-race-top-grants
2. "R.I. among 10 winning 'Race to the Top' millions," *The Providence Journal*, August 24,2010.
3. Gina M. Raimondo, *Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System,* June 2011. Available at: http://www.treasury.ri.gov/documents/SPRI/TIN-WEB-06-1-11.pdf
4. Per capita liability calculated by dividing total pension liability estimate by Rhode Island population. Sources: Pew Center on the States, "The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Costs," (Washington, DC: April 2011). Available at: http://www.pewcenteronthestates.org/uploadedFiles/Pew_pensions_

retiree_benefits.pdf ; United States Census Bureau, fiscal year 2009 data.

5. Gina M. Raimondo, *Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System.*

6. Rhode Island Public Expenditure Council, "Rhode Island's Pension System: Reforms Are Needed Now to Keep Pension System Sustainable," March 2010.

7. Gina M. Raimondo, *Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System.*

8. Gina M. Raimondo, *Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System.*

9. Employees' Retirement System of Rhode Island Handbook, September 2010. Available at: https://www.ersri.org/public/documentation/Membership&RetirementHandbook_Sept2010.pdf

10. Gina M. Raimondo, *Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System*; Employees' Retirement System of Rhode Island Handbook.

11. Employees' Retirement System of Rhode Island Handbook.

12. For a more full explanation, see Chad Aldeman and Andrew J. Rotherham, *Better Benefits: Reforming Teacher Benefits for a Changing Work Force* (Washington, DC: Education Sector, August 2010). For the underlying research, see, for example, Robert Gordon, Thomas J. Kane, and Douglas O. Staiger, "Identifying Effective Teachers Using Performance on the Job," The Hamilton Project (Washington, DC: Brookings Institution, April 2006).

13. Richard Woodbury, *Population Aging and State Pensions in New England* (Boston, MA: New England Public Policy Center, June 2010).

14. Ann Duffett, Steve Farkas, Andrew J. Rotherham, and Elena Silva. *Waiting to Be Won Over: Teachers Speak on the Profession, Unions, and Reform* (Washington, DC: Education Sector, May 2008).

15. Assumes annual inflation at 3.16 percent, the average rate of inflation from 1981-2010, Bureau of Labor Statistics.

16. Robert M. Costrell and Michael Podgursky, *A Modest Proposal for Pension Reform* (Cambridge, MA: Education Next, Fall 2011).

17. A cursory review of marginal tax rates shows that Rhode Island's rates are comparable or lower than neighbor states. Municipalities have raised property taxes to fund local pension plans, which are also included in the proposed pension reform.

18. Chad Aldeman and Andrew J. Rotherham, *Better Benefits: Reforming Teacher Pensions for a Changing Work Force.*

19. Robert M. Costrell and Michael Podgursky, *A Modest Proposal for Pension Reform.*