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The Case for Public Pension Reform: Early Evidence From Kentucky

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I. Introduction

_The great enemy of freedom is the alignment of political power with wealth._

Over the past few years public pensions have moved from the extreme and obscure periphery of American politics toward the churning center. It is hard to find even an unsophisticated citizen who is unaware of the ongoing bankruptcy in the City of Detroit\(^2\), the pension crisis in Illinois\(^3\) or the bankruptcies of Stockton and San Bernardino, California\(^4\) Public pensions (and other post employment obligations, specifically health care), are penetrating the public’s consciousness as they begin to threaten the ability of states and municipalities to perform the normal functions of government forcing a painful choice: dramatic tax increases and/or painful cuts in services.

\(^1\) WENDELL BERRY, THE ART OF THE COMMONPLACE: THE AGRARIAN ESSAYS 93 (Norman Wirzba ed. 2002) (Berry is a resident of Henry County, Kentucky)


\(^3\) Illinois is the “worst-funded state pension system” in the union, with a $100 billion shortfall, which is $374 billion over the next 30 years. See Monique Garcia & Ray Long, _Illinois Approves Major Pension Overhaul_, CHI. TRIB., Dec. 4, 2013, http://www.chicagotribune.com/news/local/ct-illinois-governors-race-pensions-met-1203-20131204,0,6561409.story.

\(^4\) Stockton filed for bankruptcy after instituting cost-cutting policies, negotiated with creditors (proving futile), paid its payments to California pension system (CalPERS), and formed a bankruptcy plan. San Bernardino failed to take any significant actions, “declared a fiscal emergency,” stopped paying bondholders and CalPERS, and then filed for bankruptcy. Tim Reid, _Analysis: Stockton and San Bernardino, A Tale of Two Bankruptcies_, REUTERS, Apr. 2, 2013, http://www.reuters.com/article/2013/04/02/us-usa-california-municipalities-idUSBRE9310YI20130402.
The small city of Central Falls Rhode Island recently experienced all of this—cuts to the city budget with resulting job losses and tax increases.\(^5\) Nothing about that situation was attractive to any of the key players, save possibly the bondholders who were largely protected. Instead of waiting for a full-on crisis and the shock of bankruptcy, many rational voices have been calling for an entirely different approach: amend public plans \textit{now} in order to avoid draconian cuts later.

This paper focuses on one state—Kentucky—that has taken this advice to heart and recently enacted substantial pension reforms. Although Kentucky has never been described as the worst state in terms of public pension finances—that honor goes to Illinois\(^6\)—this small state of only 4.38 million people

\(^{5}\) I have written elsewhere in detail about the Central Falls case and the bankruptcy court’s decision to protect bondholders at the expense of taxpayers. See Maria O’Brien Hylton, \textit{Central Falls Retirees v. Bondholder: Assessing Fear of Contagion in Chapter 9 Proceedings}, WAYNE L. REVIEW (Forthcoming 2014)(on file with author). Central Falls filed for Chapter 9 bankruptcy when “it had approximately $80 million in unfunded pension liabilities, and was running an annual budget deficit of about $5 million per year.” \textit{Id} at 1. Central Falls was deeply impacted: [T]he restructuring that was approved imposed virtually all of the cost onto current and former municipal employees and taxpayers. Indeed, city services were slashed as an astonishing one-third of public employees were fired at the same time that a 4% increase in property taxes was imposed for fiscal 2012 through 2017. Current retiree’s pension payments were reduced approximately 55% and cost of living adjustments (COLAs) were eliminated. \textit{Id.}

\(^{6}\) In 2013, the Illinois had a $100 billion unfunded liability, and “continues to have the worst funded system with a 40.4% funded ratio” and it would cost $7,421 per Illinois taxpayer to fully fund the system. “Rachel Barkley, \textit{The State of State Pension Plans 2013: A Deep Dive Into Shortfalls and Surpluses,} Morningstar INC., 4 (Sept. 16, 2013), http://global.morningstar.com/CityPensions2013/Excerpt_StateofCityPensions2013.pdf, “The poor fiscal health of the Illinois pension plans is due to a combination of reasons, including historical borrowing from the plans by the state, state law requiring annual funding of less than the annual required contribution, below expected investment returns and weak funding methods.” \textit{Id.} at 4. To actually pay back the entire pension, and all backlogged bills related to this, it would cost about $32,000 per person. Elise Hu, \textit{Illinois Pension Crisis: This is What Rock Bottom Looks Like,} N.P.R., June 15, 2013, http://www.npr.org/blogs/itsallpolitics/2013/06/15/191619059/illinois-pension-crisis-this-is-what-rock-bottom-looks-like. Illinois pension liability is effecting everything in the stat, where the S&P has downgraded Illinois’ bonds, thus the borrowing cost of the state have risen and “[e]very time they want to build a bridge or new school, it’s going to make it more expensive and possible a lot more expensive.” \textit{Id.} In December 2013, the Illinois legislature attempted to reform the pension crisis by curbing the annual COLA increases and increasing the retirement age for current workers, with the goal to “close the state’s worst-in-the-nation $100 billion unfunded public pension liability within 30 years.” Ray Long & Rick Pearson, \textit{Major Union Groups Sues to Overture Illinois Pension Law,} CHICAGO TRIBUNE, Jan. 28, 2014, HTTP://ARTICLES.CHICAGOTRIBUNE.COM/2014-01-28/NEWS/CHI-MAJOR-UNION-GROUP-SUES-TO-OVERTURN-ILLINOIS-PENSION-LAW-20140128_1_PENSION-LAW-PENSION-SYSTEMS-ONE-ILLINOIS-COALITION. The Illinois AFL-CIO, the American Federation of State, County and Municipal Employees, the Service Employees International
sponsored plans that were only 30% funded as of 2012. By April 2013, however, Kentucky enacted legislation that creates a cash balance-type plan for all new employees and requires the state to begin fully funding its annual required contribution in 2015. How and why did this small state with a long and unattractive history of financial misbehavior manage to confront its crisis before it was forced to

Union, the Illinois Federation of Teachers, the Illinois Education Association and other public unions recently filed a lawsuit challenging the legality of the changes. The lawsuit claims that “the workers upheld their end of the bargain by paying into the pension throughout their careers but that governors and lawmakers short-changed the systems for decades, causing the shortfall to grow dramatically.” The challenge to the law is based on the “Illinois constitution which declares public pensions a ‘contractual’ relationship with benefits that cannot be ‘diminished or impaired.’” Also, the unions argue that the law amounts to theft because, under the takings clause of the Illinois constitution, “a person’s private property . . . [cannot] be taken away for public use without ‘just compensation.’”

It is also worth nothing that Puerto Rico has an “aggregate 11.2% funded level and a . . . per capita of greater than $8,900.”

“[In 2002, the pension plan for state workers not in hazardous positions was 111 percent funded. Just a decade later, it was less than 30 percent funded.” The Pew Charitable Trusts & Laura and John Arnold Foundation, Kentucky’s Successful Public Pension Reform, Issue Brief, Pew Charitable Trusts 2, (Sept. 2013), http://www.pewstates.org/uploadedFiles/PCS_Assets/2013/2013-09-27-KentuckyPensionReform-Brief.pdf. The Kentucky Employees Retirement System, County Employees Retirement System, State Police Retirement System, Judicial Retirement Fund, and Legislators Retirement Fund account for about $25 Billion in liabilities with about $13 Billion being unfunded. The Kentucky Teachers Retirement System contains about $26 Billion in liabilities with about $12 billion unfunded. (see Table 1 for a comprehensive breakdown of the funding and liabilities of the eight different retirement plans in Kentucky). The funding shortfalls resulted from benefit changes, investment returns falling short, assumptions not met, changing assumptions, cost of living adjustments, and employer contribution shortfalls. The majority of the damage resulted from “policymakers regularly shortchang[ing] the Kentucky Retirement Systems” and in order for the “pension plans to be sustainable, consistent funding over the next 30 years is a necessity” Further, the COLA were consistently approved by legislature throughout the years, however they were not paid for resulting in $1.8 billion additional to the debt form 2006 to 2011."

“Employees . . . participation in the systems on or after January 1, 2014 shall receive . . . [a] retirement benefit . . . known as the hybrid cash balance plan” Ky. REV. STAT. ANN. § 61.597(1) (West 2013); K.Y. Senate Bill 2 (2013)(reques fully funding of the ARC by 2015).

See generally Chris Tobe, Kentucky Fried Pensions: A Culture of Cover Up and Corruption (2013). The Kentucky Retirement System is in terrible shape for many reasons, including “diversion of funds due KRS by elected officials; questionable investments; investment underperformance and losses from a stuttering economy; reduced tax revenues; and unfunded mandates, like COLAs. Frank Goad, Kentucky Pension Shortfall a Potential Bankruptcy Bomb, LANE REPORT (Feb. 6, 2013), http://www.lanereport.com/18327/2013/02/kentucky-pension-shortfall-potential-bankruptcy-bomb/. “In 2012, Kentucky had one of the worst funded retirement systems. The total unfunded liability in pension plans covering employees other than teachers was $13.9 billion- more than the tax revenue the
consider even more painful choices? I argue that increased transparency and a carefully crafted political consensus pushed lawmakers to undo years of short term horizon thinking, political corruption and the usual moral hazard story in favor of long term planning that should improve the state’s finances over the long term. The Kentucky story is both a common cautionary tale of years of over promising by elected officials eager to placate public sector unions and an optimistic narrative about the positive consequences of increased transparency.

In section II I briefly review the financial state of Kentucky’s plans and the corruption plagued environment in which “funding” and “investment” took place for many years. In section III I describe the reform process, the details of the new plan requirements and evaluate the prospects for replication in other financially stressed states. In particular I describe the hybrid cash balance vehicle as superior to the traditional defined benefit plan for public employees. Section IV focuses on the role of transparency and argues that the trend toward greater information for citizens and taxpayers, as evidenced by the recent GASB rule changes for public plans, can only help to create an environment of informed urgency needed for meaningful reform. Section V concludes and offers some suggestions, based on the Kentucky experience, for similarly situated states and municipalities.

II. Corruption, Scandal and Short Term Thinking

The motto of the Commonwealth of Kentucky is “United We Stand, Divided We Fall”\(^{10}\). Until the Kentucky legislature stepped in in the spring of 2013, the state came perilously close to the utter collapse of its pension plans—what would have been a major fall indeed. What exactly it would have

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state collected that year.” The Pew Charitable Trusts & Laura and John Arnold Foundation, Kentucky’s Successful Public Pension Reform, Issue Brief, Pew Charitable Trusts 2, (Sept. 2013), see Pew Center, supra note 9. The cost to state and local governments to meet the required pension contributions, per year and if nothing was done, would be $1.37 Billion in 2020 and $3 Billion by 2031. Id. “And for every dollar spent on worker pay, another 37 cents would have to go for pension promises.” Id.

meant to “fall” under these circumstances is not entirely clear; however, once the financial predictions went from bad to dire, the political class finally mustered the support necessary for meaningful reform.

The Kentucky Retirement Systems (KRS) consists of plans for three broad groups of employees: the state police, employees of the counties (CERS) and the general Kentucky Employees Retirement System.11 KRS is basically an umbrella organization that provides management services to employees of more than 1600 states agencies. KRS has approximately 334,000 members12 that include employees of state supported universities (non-teaching staff), employees of local health departments and mental health agencies and various employees of state government.13 The County plan includes employees of city and county government agencies, police and firefighters, librarians and various other employees who work for the local boards of education in non-teaching positions. The State Police plan includes, as expected, state police officers. The KRS and the CERS both categorize plan participants on the basis of hazardous or non-hazardous status.14

A. The Pre-2014 Defined Benefit Plan

Like many states, Kentucky offered its employees a traditional defined benefit plan managed by the KRS. The defined benefit was determined by length of service and an employee’s final average

11 There are three additional retirement funds in Kentucky which are not part of KRS: the Kentucky Teachers’ Retirement System (KTRS), the Kentucky Judicial Retirement System (KJRS) and the Kentucky Legislators Retirement System (KLRS). The Teachers plan was unaffected by the changes discussed in this paper. All new judges and legislators were moved to the Hybrid Plan (discussed infra) as of January 1, 2014.
14 KY. REV. STAT. ANN. § 61.592(1)(a) (West 2013) defines as hazardous
   1. [a]ny position whose principal duties involve active law enforcement, including the positions of probation and parole officer and Commonwealth detective, active fire suppression or prevention, or other positions, including, but not limited to, pilots of the Transportation Cabinet and paramedics and emergency medical technicians, with duties that require frequent exposure to a high degree of danger or peril and also a high degree of physical conditioning;
   2. [p]ositions in the Department of Corrections in state correctional institutions and the Kentucky Correctional Psychiatric Center with duties that regularly and routinely require face-to-face contact with inmates.

The definition of “hazardous” is similar for County employees. See KY. REV. STAT. ANN. § 61.592(b) (West 2013).
salary and a retirement multiplier. The meant that the state took full responsibility for managing the plan’s assets in order to ensure that all obligations under the plan could be met. The retirement benefit was paid out for the remainder of the participant’s lifetime and the final average salary was typically determined by the average of the highest three or five years of salary. A 1.5% cost of living (COLA) increase was guaranteed by statute, although this was rescinded in 2012 and 2013 and ultimately eliminated as part of the 2014 reforms.\textsuperscript{15} Like most of these public defined benefit plans, funding came from employee contributions, state contributions and investment gains from performance of the plan’s assets.\textsuperscript{16}

For a variety of reasons which are discussed in further detail below, Kentucky repeatedly failed to make the state’s contributions over a substantial period of time. This resulted in a total unfunded liability for the plan of $18 billion—one of the worst funded plans in the entire country.\textsuperscript{17} By the time

\begin{quote}
\textsuperscript{17} See Mike Wynn, Pension Reform Passes Kentucky Legislature, Courier-Journal (March 26, 2013) available at 2013 WLNR 7525179. “The Kentucky Retirement Systems . . . faces $18 billion in unfunded liabilities and administers one of the worst-funded plans in the nation.” Id. This number increases to “$33 billion in unfunded pension liabilities when counting Kentucky Retirement Systems and other pension plans for teachers, lawmakers, and judges.” Id. The unfunded liability is growing each year considering the “[i]nvestment yields that are supposed to produce two-thirds of system funds were stunned by the 2008 economic crisis.” Frank Goad, Kentucky Pension Shortfall a Potential Bankruptcy Bomb, Lane Report (Feb. 6, 2013), http://www.lanereport.com/18327/2013/02/kentucky-pension-shortfall-potential-bankruptcy-bomb/. The situation was exacerbated “because successive administrations and legislatures have been shorting appropriations to the pension systems for more than a decade, cutting the financial seedstock that was to compound for investment.” Id. The unfunded liability raised increasing since 2000 because “in biennial Kentucky budgets the legislature did not fund approximately $800 million of the $1.8 billion the state was obligated to have paid into the system” increasing the funded gap because the system did not receive the investment return it would have received from these contributions. Id. For example, “the funding gap for the retirement systems has grown by roughly $3 billion in the last year alone.” Id. To fix this problem, “many say there are essentially two choices: the state declares the pension system bankrupt to shed some of its obligations, or it doubles the sales or income tax and commits all the added revenue to KRS.” Id. The only true solution for Kentucky to pay reduced benefits for current retirement system members is to declare bankruptcy for the state’s pension systems. Even if a state wanted to file bankruptcy, a judge might not allow it. In 2012,
the legislature made fundamental changes to the KRS plan in the spring of 2013, the staggering scope of the problem in Kentucky had begun to attract national attention. The Pew Charitable Trust,18 The Mellman Group19, and Morningstar20 had all noted the seriousness of Kentucky funding predicament and concern about a “cultural” inability of the legislature to implement needed reforms surfaced.21 Morningstar, for example, reported that Kentucky’s pension solvency issues were significant as “[o]verall, the state’s plans are at a very low 46.8% funded level with an unfunded liability of roughly $5000 per capita.”22

The Pew Center on the States notes that “devastating market losses”, “repeated failures” by the state to make its contributions, unfunded COLAs and faulty actuarial assumptions explain most of the shortfall.23 And, of course, the longer these problems remain unaddressed, the more intractable they

18 “In 2012, Kentucky had one of the worst-funded retirement systems in the country. The total unfunded liability in the pension plans covering employees other than teachers was $13.9 billion—more than the tax revenue the state collected in that year.” The Pew Charitable Trusts & Laura and John Arnold Foundation, Kentucky’s Successful Public Pension Reform, Issue Brief, Pew Charitable Trusts 2, (Sept. 2013), http://www.pewstates.org/uploadedFiles/PCS_Assets/2013/2013 KentuckyPensionReform-Brief.pdf.
19 “Kentucky voters favor moving to a new retirement system for future public employees.” Memorandum from the Mellman Group and Public Opinion Strategies to the Pew Charitable Trusts on Voters Support Moving to a New Kentucky Retirement System 1, 4 (March 2013) http://www.pewstates.org/uploadedFiles/PCS_Assets/2013/Pew_Kentucky_polling_memo.pdf. (describing a poll conducted of Kentucky voters asking questions concerning the proposed changes compared to the new system).
20 “While, Morningstar views this as a positive step [the April 2013 pension reform bills] for the state to being managing its pension liability, the state will still have a large hill to climb in order to achieve pension solvency. Rachel Barkely, The State of State Pension Plans 2013: A Deep Dive Into Shortfalls and Surpluses, Morningstar Inc., 5 (Sept. 16, 2013), http://global.morningstar.com/CityPensions2013/Excerpt_StateofCityPensions2013.pdf. The funded ratio for each retirement system in Kentucky, as of June 30, 2012, is: Employees 29.07; State Police 40.1%; Judicial 55.7%; Legislators 57.2%; and Teachers 54.5%. Id. at 25.
21 After working for two large public pensions for one year, “my conclusion was that KRS was mired in a culture of corruption.” CHRIS TOBE, KENTUCKY FRIED PENSIONS: A CULTURE OF COVER UP AND CORRUPTION 11 (2013). “In Kentucky, the state legislature regulates [state pensions] primarily by passing laws. This has led in many states to no real oversight, leaving a corrupt system that answers to no one.” Id. at 95. (the author runs his own investment consulting firm and was a trustee for the Kentucky State Retirement system from 2008 to 2012) Id. at 3. “The culture of cover up and corruption needs to stop.” Id. at 158
22 Barkely, supra note 20, at 5.
23 Kentucky’s Pension Challenges: Opportunities for Real Reform, The Pew Center on the States, 3 (August 2012), http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Kentucky_Pension_Challenges.pdf. (“The unfunded liability increased for multiple reasons, including: The devastating stock market losses of recent years
become: “as the unfunded liability grows, so, too, does the following year’s recommended contribution. Currently, 63 cents of every taxpayer dollar that goes in to the Kentucky Retirement System pays for past promises rather than for new benefits.”

B. 2014 Plan Amendments

In early 2014, after considerable wrangling but also surprising unity, the Kentucky legislature passed House Bill 404 and Senate Bill 2 which fundamentally reformed the KRS system for future hires. Most important, all employees hired on or after January 1, 2014 will be enrolled in a hybrid cash balance plan. The defined benefit plan is now closed to new participants. New judicial employees and legislators will no longer have access to the old plan, nor will employees classified as non-hazardous. Like other cash balance plans each employee will have a hypothetical account to which 4% interest will

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24 Id. at 5. (emphasis added)
25 “A member of the Kentucky Retirement System or County Employees Retirement System [who is non-hazardous employee], whose participation in the system beings on or after January 1, 2014, shall receive the retirement benefits provided by this section in lieu of retirement benefits provided under KRS 61.559 and 51.595. The retirement benefit provided by this section shall be known as the hybrid cash balance plan.” KY. REV. STAT. ANN. § 61.597(1) (West 2013)
26 See Cooper v. IBM Personal Pension Plan, 457 F.3d 636 (7th Cir. 2006) (deciding the first appellate decision case on cash-balance plan under ERISA). The court described the cash balance plan at issue:
[t]he IBM Personal Pension Plan is a cash balance defined-benefit plan. It is almost, not quite, a defined-contribution plan. Although each employee in a defined-contribution plan has a fully funded individual account, the personal account in a cash-balance plan is not separately funded. Instead IBM imputes cash to the account in the form of “credits”: there are pay credits (set at 5% of the employee’s gross taxable income) and interest credits (set at 100 basis points above the rate of interest on one-year Treasury bills). A trust holds assets that may (or may not) be enough to fund all of the individual accounts when workers quit or retire.

Id. at 637. In a related case on cash balance plans and ERISA, the court describes more generally cash balance plans:
[t]he employee participating in a cash balance plan has a “notional” retirement account (notion because the individual account is not funded) to which every year the employer adds a specified percentage of the employee’s salary plus interest at a specified rate on the amount in the account. If the employee remains employed by the plan sponsor until retirement age, either the balance in his notional retirement account will be used to purchase an annuity for him or, if he prefers, he can receive the cash balance as a lump sum.
be paid plus a share of investment returns. Basically, each employee is guaranteed a 4% return on her contributions; additionally, the employee splits with the fund any investments returns—75% to the participant and 25% to the fund. The cost of living increased which was guaranteed under the defined benefit plan is no longer payable unless the legislature authorizes pre-payment. And, the state has committed itself to fully funding its actuariaually required contribution (ARC) every year going forward.

Full funding, which was consistently ignored by the legislature, for many years is apparently addressed by the new law. Senate Bill 2 mandates full funding by 2015 and requires the state to make 100% of its contribution each year. Basically, funding is expected to come from the following sources:

Ruppert v. Alliant Energy Cash Balance Pension Plan, 726 F. 3d 936, 938 (7th Cir. 936).

27 The Senate Bill 2 did “amend KRS 6.521, 21.405, and 61.691 to end the cost-of-living adjustments for members of the Legislators’ Retirement Plan, the Judicial Retirement Plan, the Kentucky Employees Retirement System, the County Employees Retirement system, and the State Police Retirement System effective July 1, 2013 and to recognize the suspension of the COLAS in place in the biennial budget; provide that the General Assembly may provide future cost-of-living adjustments if the COLAs are prefunded at the time of enactment.” Ky. Senate Bill 2 (2013), available at http://www.lrc.ky.gov/record/13rs/SB2.htm. Furthermore, the recipients of pension benefits from Legislator’s Retirement Plan, Judicial Retirement System, and Kentucky Employees Retirement System will only receive a COLA increase of 1.5% if:

1. The funding level of the plan is greater than one hundred percent (100%) and subsequent legislation authorizes the use of any surplus actuarial assets to provide and increase in retirement allowances described by this subsection; or
2. The General Assembly appropriates sufficient funds to fully prefund the increase described by this subsection in the year the increase is provided.

KY. REV. STAT. ANN. § 6.521(3)(b)(1-2) (West 2013); KY. REV. STAT. ANN. § 21.405(5)(a)(1-2) (West 2013); KY. REV. STAT. ANN. § 61.691(2)(a)(1-2) (West 2013). See also Section 16 of 2013 KY. Acts ch. 120 Section 81 ("Notwithstanding any other provision of this Act to the contrary, the amendments in Sections 16, 25, and 69 of this Act shall in no way nullify the provisions of 2012 Ky. Acts Ch. 19, Part I.(4), 2012 Ky. Acts Ch. 68, Part I, 2.(2), or 2012 Ky. Acts Ch. 144, Part IV, 10., which suspended the cost-of-living adjustment that would have been provided to retirees and beneficiaries of the Legislative Retirement Plan, the Judicial Retirement Plan, the State Police Retirement System, the Kentucky Employees Retirement System, and the County Employees Retirement system on July 1, 2012 and July 1, 2013.")

28 Note that for the last 21 years the Kentucky Legislature only authorized funding for its full share of the required contribution 14 times. Jason Bailey, State Must Begin Meeting Responsibility to Teachers Retirement or Pay More Later, November 21, 2013, Kentucky Center for Economic Policy, available at http://www.kypolicy.org/content/state-must-begin-meeting-responsibility-teachers-retirement-or-pay-more-later ("Everyone knows the state should make the full contribution, but it hasn’t done so for 14 of the last 21 years."). It is not possible to overstate the degree to which the funding crisis was the creation of political actors. See Pew Center, supra note 23, at 3. (noting that the KERS funding was affected by “repeated failures by the state to make its annual recommended contribution in full caused the gap to grow by about $1 billion. Another $1 billion was the result of cost-of-living adjustments that were given without adequate funding.) The recession of 2008 exacerbated an already weak plan, but the chronic inability of the political actors to honor their commitments to the plan explain much of the underfunding. Id. at 3-4 ("the devastating stock market loses of recent years added approximately $1 billion to the shortfall as expected investment returns did not materialize.") While many factors,
• A reduction in the $20 tax credit for each taxpayer, spouse and dependent. This is expected to raise an additional $32.5 million in revenue;

• Changes to the American Taxpayer Relief Act of 2012 are expected to raise $30 million;\(^29\)

• Various changes to the Kentucky code, including changes in fees for car registration, and professional licenses.\(^30\)

Like the 2008 recession, were not under political control, “the single factor that is most firmly in the hands of state leaders is the amount the state contributes to the fund each year. Since 2004, the state has had a poor record. . . has not paid a sufficient amount into the fund” to pay for required benefits. Id at 4. Even when Kentucky’s politicians finally enacted reforms in 2013, they did not go far enough because the reforms “passed on teacher’s retirements, effectively kicking the can down the road, and directly at the next governor.” Jonathan Meador, Like ‘The Walking Dead’: Kentucky’s Pension Liabilities Creating Nightmare Scenarios, WKU Public Radio (Jan. 23, 2014), http://wkyufm.org/post/walking-dead-kentuckys-pension-liabilities-creating-nightmare-scenarios. Kentucky politicians and pension plan employers have known that political decisions have greatly effected the funding of the retirement system. See Ky. Retirement Systems, supra note 12, at 4 (“The underfunding, along with past benefit increases, [and] unfunded annual cost of living allowances . . . has resulted in a decline of funding ratios.”); John Cheeves, “Kentucky’s Underfunded Pensions: Are Bonds the Answer?”, Lexington Herald-Leader, (Nov. 10, 2012), http://www.kentucky.com/2012/11/10/2403333/kentuckys-pensions-are-woefully.html (“The General Assembly repeatedly sweetened retirement benefits for public workers while failing to set aside enough money to keep the systems solvent . . . . Last year, despite knowing of the looming problem, the legislature contributed only 51 percent of the recommended sum to the pension fund for most state workers.”).

\(^29\) This Act “reinstates the limitation on certain itemize deductions . . . [they] are reduced by three percent of the amount by which adjusted gross income exceeds a specified threshold. Kentucky’s Office of the Budget Director has estimated that reinstatement of the limitation will increase state revenue by $30 [million].” Steel, Kennon, Ogden, Tax Tinkering- $100 M, Really?, http://www.skofirm.com/sites/default/files/publications/tax-tinkerization-100m-really-4703.pdf (providing a substantive and in depth look into the various tax changes outlined above).

In case of an individual whose adjusted gross income exceeds the applicable amount, the amount of the itemized deductions otherwise allowable for the taxable year shall be reduced by the lesser of—

(1) 3 percent of the excess of adjusted gross income over the applicable amount, or

(2) 8- percent of the amount of the itemized deductions otherwise allowable for such taxable year Under 26 U.S.C.A. § 68, “Overall Limitation on Itemized Deductions

26 USCA § 68 (approved Jan. 16, 2014)

\(^30\) The changes in Kentucky Tax code, categorized as technological and compliance changes, is expected to increase tax revenue by $37.4 million. Governor Steve Beshear’s Communications Office, Governor, Legislators Approve and Fund Historic Pension Reform, March 26, 2013, http://migration.kentucky.gov/newsroom/governor/20130326pensionreform.htm. The substantive changes to the Kentucky Tax Code include;

• Revoking professional license and driver’s license, and denial of car registration for delinquent taxpayers. KY. REV. STAT. ANN. §§ 131.1817; 131.190; 186.570 (West 2013).
It is important to note that the Teachers Retirement System was not part of these changes which means that the state has not committed itself to making its required contribution to the KTRS. Since 2009 the state has failed to make its full required contribution. By 2016 it is estimated that KTRS will need an infusion of about $400 million in order to compensate for this shortfall.

- Out of state retailers must notify purchasers of tax obligations if the product bought is going to be used in Kentucky. Ky. Rev. Stat. Ann. § 139.450 (West 2013)

See Steel, Kennon, Ogden, Tax Tinkering– $100 M, Really?, http://www.skofirm.com/sites/default/files/publications/tax-tinkerization-100m-really-4703.pdf (providing a substantive and in depth look into the various tax changes outlined above).


32 “The head of Kentucky Teacher’s Retirement System says the state will need to ante up an additional $400 million a year in the next budget to shore up pension benefits and compensate for years of underfunding” Mike Wyn, Official Says Teacher Retirement System Needs Additional $400 Million a Year”, Courier- Journal, Sept. 26, 2013, http://blogs.courier-journal.com/politics/2013/09/26/officials-says-teacher-retirement-system-need-additional-400-million-a-year/. The executive secretary, Gary Hardman, also noted that “The state is in a position where the longer it puts it off, the worse it is for the state and the worse it is for taxpayers.” Id. The state could easily have avoided these payments and extra costs if it had allocated money in previous budgets, Hardman said “We’ve asked every year along the way. This is like an amortization payment—it keeps compounding and growing because those funds aren’t there.” Id. The investment losses from the economic crisis affected the overall funding of the system, but it could have been a much less costly fix:

[in 2009, only $60 million was needed to make up the shortfall. But since those contributions have not been made for six consecutive years now—and as the full impact of the economic downturn was absorbed by the system—the liability increased dramatically. In the new budget, the system needs approximately $390 million in additional money in 2015, and $400 million in 2016 to be actuarially sound. That level of contribution (around 10 percent of what the state spends on teachers salaries) will need to be maintained for the next 30 years to pay off the liability.

Bailey, supra note 28. The system is 54.5 percent funded and “[t]he lower that ratio drops, the harder it will be for the system to meet its investment earning targets because it will have to shift its portfolio away from long-term, higher return investments in order to maintain the liquidity needed to pay benefits.” Id. Governor Beshear refused to include the KTRS request for funds from the 2014 budget stating “we don’t have any money to infuse into that system at this time.” John Cheeves, Beshear Proposes State Budget that Boosts School Spending, Cuts Many Other Programs, LEXINGTON HERALD-LEADER, (Jan. 21, 2014), http://www.kentucky.com/2014/01/21/3045473/beshear-proposes-state-budget.html. KTRS is in good shape compared to the KRS, but new federal accounting Rules (GASB
So, the Kentucky story is both one of dramatic change—the elimination of COLAs unless prefunded along with a promise to make all required contributions and to share some of the risk of poor fund performance with plan participants—and status quo. The Teachers Plan, which continues to be underfunded, will require some combination of restructuring and additional funding going forward. For now, the Teachers Plan remains on the state’s to-do list.

The failure of the Kentucky Legislature to address the whole panoply of pension issues before it should not detract from the laudable steps it has taken thus far. In the face of very poor funding levels—80% or more is generally viewed as good and KRS was below 50%—the state has managed to take promising steps toward improved solvency. This is no small feat especially against the backdrop of a political culture that seems to have ingrained in it an extremely relaxed view of the appropriate manner in which to allocate and spend public tax dollars. As the Pew Center on the States recently noted what is really needed is a willingness to adopt “fiscal discipline...in both good times and bad. Without this discipline, no system is sustainable.” These early reforms, assuming they are evidence of a new willingness to align promises to employees with ability to pay, appear to be reasonable first steps towards a lasting improvement. Many states—Wisconsin most notably—have demonstrated that it is possible to commit to a set of pension promises that provide for retirement security without exposing the state to draconian financial outcomes such as those that the neighboring state of Illinois is facing.

Statement 67 and 68), will cause the unfunded liability to be recalculated from $12 billion to $23 billion if there are no changes to the fund. Id. Tom Sheldon, chairman of the KTRS board of trustees and school superintendent, stated that “We’re putting that system at risk. It’s part of our education system, and it should be considered that way.” Id.  
33 For a colloquial and sometimes hilarious account of the (mis)management of public pension funds in Kentucky, see Tobe, supra note 21. Tobe describes a longstanding and interconnected set of corrupt practices that consistently resulted in poor investment choices for KRS and ill served the plan’s participants. [Mike—insert any representative quotes here and cite.]  
34 Kentucky’s Pension Challenges: Opportunities for Real Reform, THE PEW CENTER ON THE STATES, 6 (August 2012), http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Kentucky_Pension_Challenges.pdf (“The state has not been making full required contributions to Kentucky teacher’s retirement since 2009.”).  
35In 2012 Wisconsin had a funding ratio of 99.9%. Rachel Barkely, supra note 30, at 19.  
36 On December 3, 2013 the Illinois legislature passed a overhaul of the government employee pension system “in an attempt to address one of the state’s most pressing financial problems.” Ray Long &
III. Toward a Culture of Responsible Accounting

I have written elsewhere about the widely accepted moral hazard story that explains well how states like Kentucky find themselves facing huge shortfalls with respect to the future liabilities of their pensions. 

Monique Garcia, Illinois Lawmakers Approve Major Pension Overhaul, Chicago TRIBUNE, December 04, 2013, http://articles.chicagotribune.com/2013-12-04/news/chi-illinois-pension-vote-20131203_1_pension-overhaul-government-worker-pension-systems-senate-democrats. The reforms are supposed to remove $100 billion form the pension shortfall over 30 years, dropping payments from $374 billion to $160 billion over the same time. Id. The reforms include raising the retirement age for many employees (up to 5 years for some), reduce or even eliminate COLA increases (most would have to skip up to 5 years of COLA increases), caps the amount of salaries eligible for retirement benefits, and enable some workers to join a 401(k) type plan. Id. In addition, the state would slightly reduce, by 1 percentage point, the employee contributions to their pension. Id. However, the reforms immediately came under fire from Unions and some state legislators, Senator Holmes state:

What we are doing is quite simply wrong. This is actually no different than a thief coming into your house at night and stealing your valuables. The difference is this isn’t a thief coming in the night, this is your elected representative coming to you, looking you straight in the eye and saying, ‘I’m going to take away your future.’ That is more than a promise broken. That is reprehensible.

Id. The AFL-CIO “called the new law an ‘attempted pension theft and it’s illegal.’” Ray Long & Monique Garcia, Quinn Signs Illinois Pension Bill, CHICAGO TRIBUNE, Dec. 5, 2013, http://articles.chicagotribune.com/2013-12-05/news/chi-illinois-pension-bill-signing-20131205_1_pension-measure-illinois-supreme-court-gay-marriage-law. The Illinois Retired Teachers Association was the first group to file a lawsuit challenging the reform contending that the law was unconstitutional because the Illinois Constitution makes public pensions an enforceable contractual relationship and benefits cannot be “diminished or impaired.” Id. On January 28, 2014 the We Are One Illinois coalition, which consists of the biggest union groups in Illinois, sued the state over the pension reforms. See Long, supra note 6. Currently, states are not allowed to file bankruptcy and receive protection in federal bankruptcy court, “but proponents say some states are so burdened that the only feasible way out may be bankruptcy, giving Illinois, for example, the opportunity to do what General Motors did with the federal government’s aid.” Mary Walsh Williams, A Path is Sought for States to Escape Their Debts Burdens, N.Y. TIMES, Jan. 20, 2011, http://www.nytimes.com/2011/01/21/business/economy/21bankruptcy.html?pagewanted=all. However, it has been suggested that Illinois may be the first state to declare bankruptcy and it would be primarily because of pensions. John Cody, Conservative Watch Dog: Pensions Could Bankrupt Illinois by 2015, CBS-Chicago, Apr. 30, 2013, http://chicago.cbslocal.com/2013/04/30/conservative-watch-dog-pensions-could-bankrupt-illinois-by-2015/, Taxpayers United President Jim Tobin states that “Illinois will be the first state to go bankrupt, unless pension reforms are implemented . . . 2015 is about right” Id.
The short version of this story, as with all stories that have moral hazard at the center, is that the degree of care that actors exhibit when spending other people’s money is too low. Specifically, political actors, often in exchange for promises of support at the polls, commit to more generous benefits than the taxpayers can realistically afford. The first sign that over promising has occurred with pension promises is often the failure of the state, as with Kentucky, to make its required contribution. Why is payment not made as promised? Well, legislators remember that they have a variety of other commitments besides pensions—public education, roads, prisons, public health—to name a few. These generally require immediate spending in order to satisfy the public’s demand for services. Pensions, on the other hand, are a future expense which can be delayed. Over time, of course, repeated delay creates a larger and larger shortfall which must one day be made up. But, that long term horizon is not the horizon for the typical politician who hopes/expects to have moved on to bigger and better things by the time the shortfall has mushroomed into a full blown crisis.

37 See Maria O’Brien Hylton, Central Falls Retirees v. Bondholder: Assessing Fear of Contagion in Chapter 9 Proceedings, WAYNE L. REVIEW (Forthcoming) (analyzing the bankruptcy in Central Falls as an example of extreme moral hazard permeating State Government’s liabilities). In 1990 Central Falls, “local politicians, eager for a revenue source, proposed building a jail to house nonviolent Federal Detainees . . . [to] provide a reliable stream of income which would help the city avoid financial collapse . . . to build the facility [Wyatt Detention Facility], Central Falls Issued $30 million in bonds . . . A few years later the city refinanced this loan which required another $38 million bond issue.” Id. at 7. The idea was for Central Falls to receive revenue based on a “per capita fee arrangement” and received increased revenue post 9-11 because of the “federal government’s increased focus on illegal immigration”. Id at 8. Central Falls, because of this increase in population, expanded the facility with an additional $47 million loan. Id at 8-9. However, this increase proved to be short lived, and by 2012, “Wyatt was barely generating enough cash to cover the required payments to bondholders; revenue for the city was nearly zero” resulting in bondholders “emphatically” reminding the City of its requirements to pay the bondholders. Id at 11. Central Falls was making the required payments by “failing to fund pensions promised to its public employees” resulting in over $80 million in unfunded pension and health obligation liabilities. Id

38 See Hylton, supra note 37, at 18 (“Well organized public employee unions deliver votes in return for modest short term gains and substantial long term gains. In effect, both political representatives and public employees decided that an optimal strategy was to borrow form future taxpayers.”); Id. at 19 n. 54 (“Cities and local governments make lots of promises: to their citizens, workers, vendors and investors. But when the money starts to run out some promises prove more binding than others. Bond lawyers have known for decades that it is possible, at least in theory, to put bondholders ahead of pensioners, but no one wanted to try it and risk a backlash on Election Day.”) See generally Maria O’Brien Hylton, Combating Moral Hazard: The Case for Rationalizing Public Employee Benefits, 45 IND. L. REV. 413 (2012) (providing a detailed discussion on the prevalence of moral hazard throughout public employee pensions).
Rational actors, such as insurers, are well aware of the constant threat moral hazard presents. Moral hazard explains the persistence of co-pays, deductibles and exclusions for intentional harm.\(^\text{39}\) The big question confronting participants in public plans and taxpayers generally is how to force political actors to spend taxpayer dollars with the same degree of care the taxpayer would. That is, how can legislators be pushed to avoid both over promising and delaying promised contributions? Only time will tell if the Kentucky Legislature is capable of the fiscal discipline it has recently tried to adopt. In the meantime, transparency, shared risk and a deep commitment to the importance of enforceable promises appear to be key.

**A. GASB and Enhanced Transparency**

In June of 2012, and without much fanfare, the Governmental Accounting Standards Board (GASB)\(^\text{40}\) issued Statement 68 which applies to governments that offer pensions to their employees. Statement 68 is designed to “substantially improve the transparency, consistency and comparability of the pension information reported by state and local governments and pension plans.”\(^\text{41}\) Statement 68 will go into effect for plans with fiscal years beginning in June 2014 and December 2015. The principal

\(^{39}\) In insurance law, “where there is no insurable interest, insurers and state regulators will generally not permit the issuance of a policy of life insurance because of the strong possibility that a hard-to-resist incentive to commit murder is created.” Hylton, *Combating Moral Hazard*, supra note 38 at 472-73, citing 3 Lee. R. Russ, Couch On Insurance § 36:78. There are major incentives, for beneficiaries who sadly decide to take it, in committing “the ultimate act of moral hazard”. *Id.; See also* California v. Rutterschmidy, 98 Cal. Rptr. 3d 390 (App.) *superseded by* 220 P.3d 239 (Cal. 2009); William Nack & Lester Munson, *Blood Money; In the Rich, Clubby World of Horsemen, Some Greedy Owners Have Hired Killers to Murder Their Animals for the Insurance Payoffs*, Sports Illustrated, Nov. 16, 1992, http://sportsillustrated.cnn.com/vault/article/magazine/MAG1004483/1/index.htm (“For a decade the cherubic 30-year-old had made a sporadic living as a hit man hired to destroy expensive horses and ponies, usually so their owners could collect on lucrative life-insurance policies”); Prudential Ins. Co. of America v. Athmer, 178 F. 3d 473, 474 (7th Cir. 1999) (dispute regarding the distribution of a life insurance policy of the deceased who was killed by his wife).

\(^{40}\) GASB is an arm of the Financial Accounting Foundation—a private, independent group that is widely recognized as the official source of generally accepted accounting principles for state and local government entities. Compliance with GASB regulations is typically enforced through the laws of individual states which require financial statements prepared consistent with GASB rules and audit processes. *Factors About GASB*, GASB, 2012, http://www.gasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175824006278&blobheader=application/pdf.

change Statement 68 demands is a move from a funding based approach on liability statements to an
ing an accounting based approach. Currently, government employers record liability on their financial
statement only if it failed to fully fund the annual required contribution (ARC) as defined by GASB.
Statement 68 will now require that liabilities, expenses and deferred costs be recorded on an accrual
basis.

Statement 68 is expected to push government employers to provide a clearer picture of the
finances of the pension plans they sponsor. This enhanced transparency will almost certainly lead to the
appearance that some plans are in financially weaker shape than previously thought. Net pension
liability will now be posted on the front of the financial statement where it is, presumably, harder to
overlook or ignore.42

The other key change GASB will now require concerns the way in which a fund can project
expected rates of return on investments. Underfunded plans will have to lower their estimated returns
and all funds will no longer be able to engage in “smoothing”—a practice that has tended to insulate
funds from market volatility but also to make plans look financially healthier even when the market is
performing poorly.

Some plan administrators and union officials have expressed concern that these reforms will
tend to distort the public’s sense of government plan health. “We’re concerned about confusion of the

42 GASB, New GASB Pension Statements to Bring about Major Improvements in Financial Reporting, December
ocumentPage&cid=1176160140567; Josh Rudolph, How the GASB’s New Pension Standards Could Make Things
Worse, HUFFINGTON POST (Aug. 7, 2012) http://www.huffingtonpost.com/josh-rudolph/gasb-new-
standards_b_1753564.html
43 Smoothing is an accounting practice “where pension system(s) spread the liabilities over time, making the funds
more reactive to volatility in financial markets.” Nanette Byrnes and Lisa Lambert, New Rules May Make Public
standards-idUSBRE5001Z20120625. Smoothing consisted of “the asset value used to calculate funded status
could be smoothed, often around five years. This had the effect of minimizing the volatility of funded status, since
market fluctuations were not immediately reflected in the asset value.” Michael A. Moran, A “Sea Change in Public
Pension Reporting on the Horizon, White Paper GOLDMAN SACHS 3 (December 2012),
numbers. If a plan has a liability of $4 billion, does that mean they need $4 billion today? No. It is an accounting number” notes Keith Brainard of the National Association of State Retirement Administrators.\textsuperscript{44} When GASB adopted Rule 45\textsuperscript{45} which initiated the focus on the underfunding of public plans years ago, the same concerns about increased transparency were raised: too much transparency would lead to public “confusion”.


\textsuperscript{45} Statement 45 was issued in July 2004 to provide more complete, reliable, and decision-useful financial reporting regarding the costs and financial obligations that governments incur when they provide post employment benefits other than pensions (OPEB) as part of the compensation for services rendered by their employees. \textit{Postemployment healthcare benefits}, the most common form of OPEB, are a very significant financial commitment for many governments.

\textit{GASB Statement 45 on OPEB Accounting by Government A Few Basic Questions and Answers}, GASB, http://www.gasb.org/project_pages/gasb_st45_basic_q&a.pdf (last visited Mar. 1, 2014). Before the institution of GASB 45, governments “followed a ‘pay-as-you-go’ accounting approach in which the cost of benefits is not reported until after employees retire.” \textit{Id}. There were problems with this approach because it did not reveal a sufficient amount of data, and “failed to account for costs and obligations incurred as governments receive employee services each year for which they have promised future benefit payments in exchange.” \textit{Id}. Post-employment benefits are a part of the salaries and benefits for employee services, thus they should be reported in the time the exchange occurs, rather than when the benefits are paid out. \textit{Summary of Statement No. 45}, GASB, http://www.gasb.org/st/summary/gstsm45.html (Last visited Mar. 1, 2014). Statement 45 will result in more transparency by requiring governments to report annual post-employment benefits cost, “unfunded actuarial accrued liabilities for past service costs,” “result in reporting the estimated cost of the benefits as expense each year during the years that employees are providing services . . . more accurate information about total cost of the services that government provides to its constituents, [and] provides better information . . . about a governments unfunded actuarial accrued liabilities and changes in the funded status of the benefits over time.” \textit{GASB Statement 45 on OPEB Accounting by Government}. The statement took effect after Dec. 15, 2006 for governments with total revenue of $100 million plus, after Dec. 15, 2007 for government with total revenues of $10 million plus but less than $100 million and after Dec. 15, 2008 for total annual revenue governments with less than $10 million. \textit{Summary of Statement No. 45}. The major issue regarding statement 45 is what discount rate should actuaries use to base interest assumptions on?. See Kevin Binder, \textit{Issues in Selecting the Discount Rate for GASB 45 Valuations}, Societies of Actuaries, June 2007, (last visited March 1, 2013) http://www.soa.org/library/newsletters/the-actuary-magazine/2007/june/iss2007june.aspx, (analyzing the various issues in discount rates under GASB 45); Rebecca A Sielman, Roscoe Haynes, Steven P. May, \textit{GASB 45: A Wake-up Call for Public Plan Sponsors}, Milliman, Nov. 1, 2009, http://us.milliman.com/insight/Articles/GASB-45-A-wake-up-call-for-public-plan-sponsors/, (“A big part of the process [GASB 45 accounting] is setting appropriate assumptions”)
To understand what is at stake, consider the controversy over forecasting investment returns for public plans. Those plans that are adequately funded will be permitted to continue to assume a rate of return that is consistent with historic averages—often 8 percent. Funds that are underfunded however (such as KRS) will have to lower their expected rate of return to 3% or 4%. “Specifically, [under these circumstances] the investment rate would have to match ‘a yield or index rate on tax exempt 20 year, AA-or-higher rated municipal bonds,’ ....” which currently hovers just about 3\%.46

To understand how drastic this change in acceptable rate of return is, consider the Illinois Teachers Plan which has been described as “notoriously underfunded”47. Currently, this plan has a funding ratio of just over 48% which is very poor. If an expected rate of return of between 3% and 4% is used, that ratio drops to less than 19\%.48

47 Id.
48 The new GASB rules and discount rates should not have an affect on pension plans where the state is making the required contributions and the plan is well funded. Id. However, “[s]tates like Illinois that are having trouble making their contributions, [are] expect[ed] to be more affected.” Id. The Illinois Teachers Retirement System, in 2012, was only 42.1% funded. Barkley, supra note 20, at 24. In May 2013, the Illinois Senate President revealed a union backed plan, however the Illinois Retired Teachers Association was extremely skeptical of the plan, characterizing it as “either jump off a cliff or I’ll shoot you.” Charles Chieppo, Illinois Lawmakers Dilemma: 2 Ways to Fix Public Pensions, Governing, May 15, 2003, http://www.governing.com/blogs/bfc/col-illinois-public-pension-reform-dilemma.html. “The teachers fund accounts for $55.7 billion of the unfunded obligation on a smoothed basis” making it the most unfunded plan, in dollar amounts, in the state. Yvette Shields, Illinois Unfunded Pension Liabilities Cross $100 Billion Mark, Bond Buyer, 2013 WLNR 27538356. Under the new statements, the rules “effect accounting reporting only and do not link accounting reporting of pension liabilities with pension funding.” Cory Eucalitto, GASB’s Ineffective Public Pension Reporting Standard Set To Take Effect, State Budget Solutions, June 5, 2013, http://www.statebudgetsolutions.org/publications/detail/gasbs-ineffective-public-pension-reporting-standards-set-to-take-effect.

GASB’s revise standards are more slightly modified continuation of a disaster than a sharp turn towards transparency and sound management. Despite attention in recent months, the near impossibility of accessing timely, comprehensive public sector financial information means that the changes will be unnoticeable for another several years. They continue to ignore basic economic truths, may encourage risky investment practices and are riddled with possible unintended consequences. They will also reduce comparability between plans. Importantly, non of GASB’s standards dictate plan funding itself. Governments remain free to do so as responsibly or, in many cases, as irresponsibly as they choose.
The fear, of course, is that armed with this information both politicians and taxpayers will take a second look at the funding, management and promised benefits of public plans. 49 Although plan...

49 GASB Statement 67 and 68 institute a new three-step process in measuring the pension liability; 1. “Projecting future benefit payments for current and former employees and their beneficiaries” including automatic COLA and other expectations of future employment related benefits, but do not have to include ad hoc changes; 2. “Discounting those payments to their present value.” Government now assumes a discount rate, and can apply rate up to 30 years, or the “long-term expected rate of return on the investments of the pension plan”. The statements changes this to only allow the longer term to be “applied to pension plans assets that are expected to be invested using a strategy to achieve the return”; 3. “allocating all the present value over past, present and future periods of employee service.” Governments, under the new statements, now must use the entry age actuarial cost method to allocate present value and to do so as a level percentage of payroll. Present value of project benefits will now start from when employees first begin earning benefits. Gov’t Accounting Standards Board, New GASB Pension Statements to Bring about Major Improvements in Financial Reporting, December 2013, http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160140567. Additionally, when calculating the pension expense, the new standards better align the pension expense with the period in which the related benefits are earned, thus having the overall effect of accelerating the expense recognition. Id. Net pension liability factors of change will be included into the calculation of pension expenses in the period which they occur, these factors include; benefits earned each year, interest on the total pension liability, changes in benefit terms, projected earnings on plan investments, and changes in plan net position from other than investments. Gov’t Accounting Standards Board, Summary of Statement No. 67, (June 2012) http://www.gasb.org/cs/ContentServer?site=GASB&c=Pronouncement_C&pagename=GASB%2FStatement_C%2FGASBSummaryPage&cid=1176160219444. When projecting benefit payments, the projection must be based on the benefit terms and legal agreements existing at the pension plans fiscal-year end and incorporate the effects of any projected salary changes, service credits, automatic postemployment benefit changes, including COLA, and any ad-hoc benefit changes which are substantively automatic. Id. Furthermore, statements 67 and 68 make substantive changes to reporting by cost-sharing multiple employer plans. Currently, the plans do not require reports to include present actuarial information about pensions, but only information in the pension plans own financial statements for the combined participating governments. The new requirements, to ensure more transparent financial information, requiring this plan type to report net pension liability, pension expense and pension related deferred outflows/inflows based on the proportionate share of the collective amounts of governments in the plan. Gov’t Accounting Standards Board, New GASB Pension Statements to Bring about Major Improvements in Financial Reporting, December 2013, http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160140567.
administrators and public unions are understandably wary of this scrutiny, it is undoubtedly a positive
development for taxpayers. Transparency and the enhanced clarity it brings are essential to the kind of reforms Kentucky was able to enact. There is mounting albeit anecdotal evidence that as transparency increases the pressure for meaningful reforms increases as well.

In Fitchburg, MA, for example, the mayor has noted that the pension reform process involves thinking broadly about all of the services a municipality offers: “[O]ne of the solutions [I’ve used] in terms of discussing it publicly is talking about this issue of trade-off. People want to know why, if their taxes are going up and services are going down, this is happening. And I had to say because we trade off current services to pay for past bills. That’s a very difficult conversation to have.” The process in both Rhode Island and in Kentucky—two states that recently enacted significant pension reforms— was similar. Enhanced clarity about the true cost in the future of benefits promised today is apparently critical to meaningful change. Gina Raimondo, Rhode Island state treasurer, has described tours around her small state to explain to taxpayers and public employees the workings of the state pension system.

Reporting requirements of defined contribution plans are not substantively effected, however the notes to financial statements should disclose classes of plan members covered; composition of the plans board; description of the plan and benefits provided; number of plan members; participating employers; nonemployer contributing entities; pension plan investments, including policies and how the fair value is determined; assumptions employed in measurement of net pension liability and any changes to those assumptions; assumption about the discount rate and impact of a one percentage point change in the discount rate; net pension liability and deferred outflows/inflows of resources; and the pension plan governing document. Id.

Lastly, the statements effect the information contained in required supplementary information section of financial reports. Defined benefit plans must include a schedule covering each of the last ten fiscal years with information on the annual money-weighted return on pension plan investments in each year, and factors that could significantly effect trends in the reported amounts on the schedules. Id. Single-employer and cost-sharing plans also must provide schedules containing information for each of the last ten fiscal years about governmental and non-governmental entities obligations including: “the beginning and ending balances of the total pension liability, the plan trust’s net position, and the net pension liability, and their components; [t]otal pension liability, plans net position, net pension liability, ratio of the plans net position to the total pension liability, the covered-employee payroll, and ratio of the net pension liability as a percentage of the covered employee payroll.” Id.


In Central Falls, “city services were slashed as an astonishing one third of public employees were fired at the same time that a 4% increase in property taxes was imposed for fiscal 2012 through 2016.” Hylton, supra note 5. The services were cut “in order to repay debtors . . . creat[ing] a domino-like effect where lack of funding for police, fire, library, hospital, prison and sanitation services results in higher crime as well as overcrowded prisons and hospitals.” Id.
and the poor plan design choices that led to near insolvency. The Mellman Group reported strong public support for pension reform in March 2013 as the legislature was considering the switch from a defined benefit plan to the hybrid cash balance plan. Mellman noted “support crosses partisan and ideological divisions. Union households, and even public employee households, support the new plan.... The more people hear the more supportive they are.”

B. Cash Balance Plans, Defined Contribution Plans and Shared Risk

The GASB’s march toward greater transparency has, without a doubt, been a major force behind greater scrutiny of public pension benefits and increased calls for meaningful reforms. There is no reason to think that Statement 68 won’t continue to push plans, administrators and public unions in that direction. The inability of financially troubled plans to continue to rely on an expected rate of return of about 8% will only increase pressure on legislatures to honor the funding promises and on unions to justify the generous benefits they negotiated.

See Mary Williams Walsh, The Little State With a Big Mess, N.Y. Times, Oct. 22, 2011, http://www.nytimes.com/2011/10/23/business/for‐rhode‐island‐the‐pension‐crisis‐is‐now.html?pagewanted=all. Ms. Raimondo, outlining the dire circumstances of the Rhode Island pension crisis, stated “[w]e’re in the fight of out lives for the future of this state. Either the pension fund runs out of money or cities go bankrupt.” Id. In a town hall meeting, when responding to the outraged head of Local 1363 of the firefighters union asking why pension were being taken away, Ms. Raimondo said “it could pay for schoolbooks, roadwork, care for the elderly and so on, or it could keep every promise to its retirees. ‘I would ask you, is it morally right to do nothing, and not provide services to the state’s most vulnerable citizens? Yes, sir, I think this is moral.’” Id. In another town hall meeting in North Scituate, after explaining the cuts to bus services, city workers salaries, police patrols and other government functions in Vallejo, Calif, Ms. Raimondo stated: “[t]hat’s not what we want for Rhode Island. That’s not the future we want for our children.” Id. A group of experts, assembled by Ms. Raimondo, sought to tackle the pension crisis by determining what pension should be and what the state could afford, first changing the “projected long‐term investment return for the pension system” from 8.25% to 7.5% instantly raising the state’s pension liability from $7 billion to $9 billion. Id. In response to this, Ms. Raimondo came under fire for “manufactur[ing] a crisis”, but she said: “This is about the truth, and about doing the right thing.” Id.

Memorandum from the Mellman Group, supra note 19, at 4.

See Mary Williams Walsh, Padded Pensions Add to New York Fiscal Woes, N.Y. Times, (May 20, 2010), http://www.nytimes.com/2010/05/21/business/economy/21pension.html?pagewanted=all. “In Yonkers, more than 100 retired police officers and firefighters are collecting pensions greater than their pay when they were working. One of the youngest . . . retired at 44 with a base pay of about $74,000 a year. His pension is not $101,33 a year.” Id. Employees are able to do this because their pensions are based on regular pay plus overtime worked. Id. In New York about 3,700 retired public workers pensions are over $100,000 a year, and is especially shocking since the average state pension is $18,000, or $38,000 for retired police officers and firefighters (this average includes part time or short term employees). Id. “Thirteen New York City police officers recently retired at age 40 with pensions above $100,000 a year; nine did so in their 30s. The plan’s public information officers said that the very young
Kentucky’s decision to offer all new hires access only to a hybrid cash balance plan points to another key issue that comes to light especially in periods of poor market performance. GASB emphasis on adoption of a reasonable rate of return is an implicit reminder that, at their core, defined benefit plans leave all of the risk of poor market performance on the plan sponsor. Over the past few decades retirees had qualified for special disability pensions, which are 50 percent larger than ordinary police pensions . . . several dozen of the highest paid . . . police retirees had disabilities related to 9/11 and (others) resulted from injuries in the line of duty.” *Id.* In Los Angeles, 841 retirees received benefits of $100,000 per year or more, with a former Assistant Police Chief receiving over $200,000 after retiring at 53 years old. Data Desk, *Six-Figure L.A. City Pension Pension*, L.A. Times, (last visited Feb. 25, 2014), http://projects.latimes.com/big-pensions/los-angeles/. 55 A defined benefit plan typically specifies a definite amount a participant will receive upon retirement, usually based on the length of reemployment and salary received during that employment, and may or may not require employee contributions. Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 455 (Dec. 2004). “[A] prototype defined benefit formula specifies that a participant is entitled at retirement to an annual income equal to a percentage of her average salary times the number of years of her employment with the sponsoring employer.” *Id.* (citing John H. Langbein & Bruce A. Wolk, Pension and Employee Benefit Law 45 (3d ed. 2000); Edward A. Zelinsky, *The Cash Balance Controversy*, 19 VA. TAX REV. 683, 687-91 (2000)).

Defined benefit plans traditionally have four major components: income is received at retirement; provide income on a periodic basis; plans are funded collectively, where the employer contributions for every employee is pooled and all employees receive their benefits from this pot; and employer is required to “fund the benefit promised to the participating employee. If the funds in the trust are inadequate to pay promised benefits, the employer is obligated to make up the shortfall. Thus . . . the risks associated with funding a defined benefit pension fall principally on the employer.” *Id.* at 456. In a defined contribution plan an employer has a fixed annual or periodic obligation to make to an employee’s plan, typically it is based on a percentage of the employee’s salary and/or related to years of service and an employee’s required contribution may or may not be defined by the plan. *Id.* The only guaranteed benefit is that which the employer and/or employee is obligated to make- the amount of benefit received at retirement is not guaranteed. *Id.* “The benefit payable at retirement is based on money accumulated in each employee’s account. The accumulated money will reflect employer contributions, employee contributions (if any), and investment gains or losses.” EMPLOYEE BENEFIT RESEARCH INSTITUTE, FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS 64 (6th Ed. 2009).

Additionally, the distribution of an employee’s account happens when the employee leaves the employer, even if the employee is short of retirement age. *Id* (citing See Patrick J. Purcell, Cong. Research Serv., Order Code RL30496, Pension Issues: Lump-Sum Distributions and Retirement Income Security, at Summary (2003)). Under a DC plan, employee usually receives a lump sum payment of their individual account. *Id* at 456-57. Furthermore, a DC plan does not pool the resources of all its employees into one account, but each individual employee has their own account made up of contributions by the employer, the employee, and any investment earnings or losses on these contributions. *Id*; see also EMPLOYEE BENEFIT RESEARCH INSTITUTE, supra at 64.

The fundamental difference between a DB and DC plan is that in a DC plan, all investment risk is put on the plan participant, whereas in a DB plan, all risk is with the employer. Zelinsky, supra at 456. In a defined contribution plan, “favorable investment results will increase benefits, while unfavorable results will decrease benefits” because the employee owns the assets in the plan, typically allocates the investments of the account and thus bears all of the risk. EMPLOYEE BENEFIT RESEARCH INSTITUTE, supra, at 66-7; Zelinsky, supra, at 469. In a define benefit plan, the employer owns the contribution since it is essentially a deferred wage. EMPLOYEE BENEFIT RESEARCH INSTITUTE, supra, at 67. All of the investment risk is held with the employer because “sponsors assume an obligation for paying a stipulated future benefit. Consequently, the employer accepts the investment risk involved in meeting this obligation. If the pension fund earns lower-than-expected yield, the employer will have to make additional contributions in order to provide the promised benefits.” *Id.*
most workers in the private sector in the U.S. have seen DB plans disappear and DC plans emerge as the only employer supported option for retirement savings.\textsuperscript{56} It is hardly surprising that the taxpayer, confronted with the information about the kind of trade offs that the mayor of Fitchburg, MA describes, begins to balk at paying for public pension benefits that are more generous than those available in the private sector.

The hallmark of a DC plan is the placement of investment risk squarely on the shoulders of the plan participant. The maintenance of traditional DB plans, combined with enhanced transparency about their true costs, cannot help but attract the attention of cash strapped taxpayers. The DB plan’s iron clad promise of benefits at a future date can only be honored via excellent management and good market returns. The recession of 2008 battered the portfolios of numerous plans\textsuperscript{57}. At the same time state finances were strained by large numbers of newly unemployed who both required additional services and stopped paying taxes. This scenario made taxpayer vulnerability to DB plans particularly easy to see over the past few years.

Kentucky’s decision to move to a hybrid cash balance option appears to strike a reasonable balance in terms of risk allocation between plan sponsor and plan participant: both share in the risk and reward\textsuperscript{58} in good times and in bad. Of course, less risk for the plan sponsor necessarily means greater risk


\textsuperscript{57} The decline of the funded ratio for some states from 2008 to 2009, due to the recession, was massive: Arkansas declined 9.7%, declined 19.1%, Maryland declined 13.6%, Massachusetts declined 16.7%, and Ohio declined 20.9%, Barkley, supra note 30, at 13-20. (showing aggregate pension data by state). From 2008-2009 the aggregate pension fund for all 50 states, DC, and Puerto Rico lost 6.1%. \textit{id.} at 20.

\textsuperscript{58} A hybrid cash balance plan, or cash balance plan, is a pension plan which an employer guarantees a specific contribution, and a rate of return on that contribution. Kenneth R. Elliot & James H. Moore Jr., \textit{Cash Balance Pension Plans: The New Wave, Compensation and Working Conditions} 3 (Summer 2000), http://stats.bls.gov/opub/mlr/cwc/cash-balance-pension-plans-the-new-wave.pdf. Cash balance plans are considered defined benefit plans, even though it incorporates characteristics of both DC and DB plans. Al Reich,\textit{Overview of Hybrid Plans (Cash Balance and Pension Equity Plans), Internal Revenue Service} 5 (CYE 2013), http://www.irs.gov/pub/irs-tege/2013cpe_Hybrid_plans.pdf. Participants each have an individual cash account, a
for the participant. The record with respect to participant education (needed to make sensible investment choices) is spotty. It is too early to tell if Kentucky’s cash balance approach will allow it to strike the proper balance between risk borne by the taxpayer and risk to the public employee. However, some off loading of risk from the state to the participants should reduce the likelihood that Kentucky’s pension finances will threaten the financial health of the entire state.

C. Enforceable Promises

In addition to transparency and appropriate risk allocation, Kentucky’s reforms highlight the importance of enforceable promises—i.e. the need for states to avoid over promising even when it is hypothetical account, but there is not any cash in the account, it is simply a record-keeping function that shows the “balance”, which includes an employer deposit of a “pay credit” and “interest credit” - no actual money is deposited into the account. Id; Elliot & Moore, supra, at 4. The employer does not actually make any contributions to the individual accounts, instead “makes contributions to the plan’s trust.” Reich, supra, at 7. The specific plan document will describe the formula that is used to determine the balance and contributions that must be made to the hypothetical account, and then the individual account balance will reflect this formula. Id. at 8. “The amount each employer contributes in to the plan each year is based on actuarial assumptions … employers can invest cash balance plan funds just like they can invest other defined benefit plan funds. Participants retirement accounts grow by earning annual credits that are typically based on a flat percentage of pay.” Elliot & Moore, supra, at 4. For example, under Kentucky’s hybrid cash balance plan an employee is guaranteed a 4% return on contributions made (by both employer and employee), and additional benefits are based on investment performance, where the employee keeps 75% and the fund receives 25%. Ky. REV. STAT. ANN. § 61.597(4)(a) (West 2013). There is less risk to municipal governments under a hybrid cash balance plan because it does not define the contributions, it is based on actuarial valuations, “benefits are expressed in terms of a lump-sum payment, and at any point in time the employer knows the value of an individuals account“, large wage increases do not have as great of influence as in a DB plan. Reich, supra, at 6-7.

Employers are reluctant to provide education to employees on investment and plan decisions because employers are worried about potentially being deemed as giving investment advice, which under ERISA could create liability as a fiduciary. Susan Stabile, Pension Plan Investments in Employer Securities: More is Not Always Better, 15 YALE J. ON REG 61, 86, n. 122, (Winter 1998).

A participant in a defined contribution plan runs the risk that there may be little or no money available to support a comfortable retirement if the mark performs poorly or investment choices prove to be unwise. For this reason, many have written about the need for high quality ‘investor education’ for employees who are participating in defined contribution plans.

Maria Hylton, Together We Can: Imagining the Future of Employee Relations, 12 EMP. RTS. & EMPLY. POL’Y J. 383, 386 (2008). Education for plan participants is needed to enable participants to make informed and fiscally smart investment decisions. Id. at 389; see also Jayne Elizabeth Zanglein, Investment Without Education: The Disparate Impact on Women and Minorities in Self-Directed Defined Contribution Plans, 5 EMP. RTS. & EMPLY. POL’Y J. 223, 268 ("All participants, including women, men, minorities, low-income workers, part-time employees, youth, and the elderly must be taught the fundamentals of investments."). A participant’s retirement well being in a defined contribution plan “will depend, if there is no organized investor education, upon such circumstances as an individuals inherent financial ability.” James A. Fanto, We’re All Capitalist Now: The Importance, Nature, Provision and Regulation of Investor Education, 49 CASE W. RES. L. REV. 105, 126 (Fall 1998) (commenting on the need for investor education)
the politically exigent thing to do. The recent argument before the U.S. Supreme Court in the Harris case could be interpreted as a manifestation of profound disillusionment by public employees with their union. Whether or not the Supreme Court ultimately overturns Abood61 Harris may be an isolated case or it may turn out to be the beginning of a string of challenges by public employees to the quality of representation they are receiving from their workplace representative. If the latter, one cannot help but wonder whether the march toward greater financial accounting transparency has inadvertently led to a

60 Harris v. Quinn, No. 11-681(U.S. argued Jan. 21, 2014). The main issue in the case is whether members of a public employee union can be compelled to pay “fair share” dues even if they believe it violates their 1st Amendment right, freedom of association, when union takes positions they disagree with. Brief for Petitioners at 3, 14, Harris v. Quinn, No. 11-581 (filed Nov. 29, 2011). Illinois law requires “individuals who provide in-home care to Medicaid recipients to accept and financially support a union as their exclusive representative for petitioning the State over its Medicaid rates and policies.” Id. at 2-3. The petitioners are personal assistants who provide in-home care to disabled participants in either the Home Services Program, known as the Rehabilitation Program, or the Illinois’s Home-Based support Services Program, the Disabilities Program, and the state pays their wages. Id at 4-5. The law, up until 2003, considered the personal assistants employee’s of the individuals they took care of, and not employees of the state, even though the state paid their wages. Id at 8. In 2003, the legislature passed a law that recognizes personal assistants under these programs as employees of the state for purposes of coverage under the Illinois Labor Relations Act. Id at 9. Subsequently, a majority of the personal assistants voted elected Service Employees International Union Healthcare Illinois & Indiana (SEIU) as their collective bargaining representative. Brief for Respondent Pat Quinn at 6, Harris v. Quinn, No. 11-581 (filed Dec. 30, 2013). The state and SEIU entered into contracts that required personal assistants, who are members of the union, to pay union dues and membership fees, and non-members to pay their “fair-share”. Id at 8. Petitioners than brought action claiming that the fair share fees violated their freedom of speech and freedom of association under the First and Fourteenth Amendments. Brief for Petitioners, supra at 13-4. “Illinois arrogated these rights [First Amendment] to itself when it forced Providers to accept and financially support an exclusive representative to petition the State about a public program in which Providers participate.” Id. Respondents argue that a union is necessary to protect the health and safety of the customers by ensuring a qualified personal assistants and to coordinate with these assistants, a union was necessary to “negotiate with the state over employment terms and conditions,” and “this cooperation between the State and the union . . . is the best way to ensure a workforce that will meet the needs of the State’s most vulnerable residents in a professional and cost-effective manner.” Brief for Respondent Quinn, supra at 12.

61 Abood v. Detroit Bd. Of Educ., 431 U.S. 209 (1977)(governing the payment of fair share union dues). The Detroit Board of Education challenged a Michigan statute that authorized employees represented by a union to pay union stating that the “[u]nion was engaged in various political and other ideological activities that [they] did not approve and that were no collective-bargaining activities” and thus should be overturned under the First Amendment as a deprivation of their First Amendment rights. Id at 209. The Court held that fair-share fees were valid because “union shop arrangement . . . distributes fairly the cost of . . . activities among those who benefit and it counteracts the incentive that employees might otherwise have to become ‘free riders’ to refuse to contribute to the union while obtaining benefits of union representation that necessarily accrue to all employees.” Id. at 232. The court also noted that “public employees are not basically different from private employees”, thus their First Amendment claims are no “weightier than a private employee in not being compelled to contribute to the costs of exclusive union representation”. Id at 229. The court also held that a union spending funds for political views not related to collective-bargaining representation is allowed, however “such expenditures be financed from charges, dues, or assessments paid by employees who do not object to advancing those ideas and who are not coerced.” Id at 236.
loss of confidence in public union leadership. Both taxpayers and union members could be forgiven for questioning, with the benefit of hindsight of course, the judgment of union leadership that negotiated often lavish benefits with little apparent concern about the state’s ability to pay.\textsuperscript{62} The sorry state of affairs that Kentucky found itself in must have some effect (albeit unquantifiable) on public confidence in elected officials, the democratic process and the values of honesty and reliability.

At the end of the day a great deal is a stake when the state commits itself to pay for future benefits. Miscalculations, malfeasance or outright incompetence undermine the confidence of both the state’s employees as well as taxpayers generally. To the extent that a state like Kentucky, aided by increased information about the financial health of its pension plans, can recover from its past mistakes, the trust of citizens in the ability of their government to function and plan with a reasonable degree of competence is reinforced.\textsuperscript{63}

\textsuperscript{62} In 2003, Illinois designated personal assistants to be state employees for purposes of collective bargaining, and subsequently SEIU was elected to represent the employees. Garrett Epps, \textit{The Supreme Court Case that Could Clobber Public-Sector Unions}, \textit{The Atlantic}, Jan. 21, 2014 \url{http://www.theatlantic.com/business/archive/2014/01/the-supreme-court-case-that-could-clobber-public-sector-unions/283232/}. Included in the new law, non-members, “require to pay a fee that is a set annual ‘chargeable’ percentage of union dues. The rational for the agency fees is that non-union employees benefit form the contracts unions negotiate, and thus would be “free riders” if the union could not charge them. \textit{Id}. The state set to establish unionization to create and retain a professional group of aids because prior to the law, turnover was massive effecting the coverage for adults. Nina Totenberg, \textit{A Union for home Health Aides Brings New Questions to Supreme Court}, NPR, Jan. 21, 2014, \url{http://www.npr.org/2014/01/21/264257440/illinois-case-brings-new-union-questions-to-supreme-court}. “No one is forced to join the union, but non-union members do have ot pay the costs of negotiating and administering the contract . . . to prevent themf rom free-riding on the dues of members.” \textit{Id}. Pam Harris, the leader and name of the case, stated: “I object to my home being a union workplace”, since she is an aide and takes care of her disabled sun. \textit{Id}. She is in the minority, but others “don’t want to deal with this organization whatsoever.” There is no claim that the fair share money was used for improper purpose, however the defense says “the question is: Can individuals be forced to support a union if they don’t want to?” \textit{Id}.

\textsuperscript{63} Chris Tobe, former trustee of KRS, commented on the Gov. Beshear’s suggestion that change will come: People don’t believe you when you say you need money because they felt they’ve been lied to for so long. So there is a whole cultural thing there that I think we need to at least get started on trying to get honest with people about what the situation is. Because, I mean, he is starting in a very big hole. Meador, \textit{supra} note 28.
An optimistic view of Kentucky’s reforms and the GASB’s ongoing efforts to increase transparency suggests that, with time, the states that fix their underfunded plans and adopt reasonable expected rates of return will not only solve an important budget issue, but, in doing so, will also increase public support for the panoply of services and activities the states do. As taxpayers begin to better understand that public pension costs are just one item in a budget and that tradeoffs are inherent in every budget decision, the much needed push back to the moral hazard problem could materialize. Politicians might be less cavalier with taxpayer dollars if and when taxpayers begin to pay attention and demand accountability for future spending commitments.

If taxpayers remain inattentive even with the added information available from Statement 68, it is hard to see a meaningful way forward for states that have yet to grapple with their underfunded plans. Political gridlock, reduced spending on critical services such as prisons, education and roads and even bankruptcy loom in jurisdictions that fail to address the promises they have made.

64 “California—recently dubbed the ‘Lindsay Lohan of states’ in the Wall Street Journal—has a deficit that could reach $25.4 billion next year and Illinoi’s deficit for the 2011 fiscal year may be in the neighborhood of $15 Billion,” and unless something happens, the states will become insolvent, and bankruptcy can save them. David Skeel, Give States a Way to Go Bankrupt, The Weekly Standard, Nov 29, 2010, http://www.weeklystandard.com/articles/give-states-way-go-bankrupt_518378.html; see generally States Most Likely to Go Bankrupt, Dailybeast, Jan. 1, 2011, http://www.thedailybeast.com/articles/2011/01/26/states-most-likely-to-go-bankrupt.html. Detroit, when it declared bankruptcy, had liabilities of $18 Billion and around 40% funded. The worst funded states in 2012 were: Illinois at 40.37; Kentucky at 46.77; Connecticut at 49.08; Louisiana at 55.86; New Hampshire at 56.25; Mississippi at 57.91; Alaska at 59.18; Kansas at 59.18; Hawaii at 59.19; and Indiana at 60.95. Most Unfunded Pension Plans: States, Bloomberg, (last visited Mar. 2, 2014) http://www.bloomberg.com/visual-data/best-and-worst/most-underfunded-pension-plans-states. There are 32 states that are considered to have serious concerns regarding failure to pay annual required contribution. The Widening Gap- Issue Breach, Pew Center on the States, June 2012, http://www.pewstates.org/research/reports/the-widening-gap-update-85899398241. A state pension is considered to be healthy if it has a funded ratio of 80% or more. Niraj Chokshi, The State Pension Situation is Improving, But Most Plan Funding is Still Low, N.Y. TIMES, Sept. 16, 2013, http://www.washingtonpost.com/blogs/govbeat/wp/2013/09/16/the-state-pension-situation-is-improving-but-most-plan-funding-is-still-low/

65 In Illinois, in order to fully fund the unfunded pension liability, each person in the state would have to pay $7,421. Berkley, supra note 30, at 2 (showing UAAL per capita figures which “represents the amount each person in the state would need to pay to fully fund this liability”). Whereas in Wisconsin, one of the best-funded states,
At the moment, Kentucky represents a small beacon of light—a way forward for states that struggle as many still do to dig out from years of financial mismanagement and over promising. It will be important to track the progress in Kentucky to see what worked and what still needs further change.67

the per capita cost is only $18. Id. Other states with high per capita payment to fully fund pension obligations: Alaska at $10,235; California at $3,587; Connecticut at $6,922Kentucky at $4,983; and Puerto Rico at $8,900. Id. at 14-20.

66 Some States do not just have short-term budget problems but have deep structural issues that had led “some members of Congress [to] fear that it is just a matter of time before a state seeks a bailout” through Bankruptcy. Mary Williams Walsh, A Path is Sought for States to Escape Their Debt Burdens, N.Y. TIMES, Jan. 20, 2011, http://www.nytimes.com/2011/01/21/business/economy/21bankruptcy.html?_r=0&sq=state%20bankruptcy&st=cse&scp=1&pagewanted=all. “Although bankruptcy would be an imperfect solution to out-of-control state deficits, it’s the best option we have, at least if we want to have any chances of avoiding massive federal bailouts of state governments.” David Skeel, Give States a Way to Go Bankrupt, The Weekly Standard, Nov 29, 2010, http://www.weeklystandard.com/articles/give-states-way-go-bankrupt_518378.html. The idea of allowing states to declare bankruptcy has been growing in recent years since the advent of the pension crisis. See generally Matthew D. Cavanaugh & Marvin E. Sprouse III, A PATHWAY TO STATE BANKRUPTCY, 30 AM. BANKR. INST. J. 12 (Oct. 2011); John S. Baker, Jr., CRITIQUE OF A PROPOSAL TO ALLOW STATE BANKRUPTCY, J. FEDERALIST SOC’Y PRAC. GROUPS 102 (Sept. 2011); David Skeel, A Bankruptcy Law--Not Bailouts--for the States, Wall St. J., Jan. 18, 2011, available at http://online.wsj.com/article/SB10001424052748703779704576073522930513; contra E.J. McMahon, State Bankruptcy Is a Bad Idea, Wall St. J., Jan. 24, 2011, http://online.wsj.com/article/SB10001424052748704881304576094091992370. This would be a unique and precedent setting experience in the U.S. Several members of Congress have said there should be no bailouts for states that go bankrupt because of poor pension choices...cite and quote

67 Obviously the failure to tackle the teachers plan remains a huge problem--“The state’s public school teachers, whose separate public pension plan faces a jaw-dropping shortfall of about $800 million, are utterly ignored in the proposed budget lawmakers will take up in the current legislative session. And every year it’s ignored, it gets worse.” Editorial, Pension Reform Leaves Out Teachers, Courier-Journal, Feb. 3, 2014, http://www.courier-journal.com/article/20140202/OPINION01/302020028/. Since 2009, the legislature has not paid its full contribution, even though it must by law. Id. The Teachers retirement system “put forward the notion of a bond issue as a way to refinance a portion of the liability and ease the state into full additional contributions over the next six years,” however this has been ignored. Jason Bailey, State Must Begin Meeting Responsibility to Teachers Retirement or Pay More Later, November 21, 2013, Kentucky Center for Economic Policy, available at http://www.kypolicy.org/content/state-must-begin-meeting-responsibility-teachers-retirement-or-pay-more-later. In 2015 the KTRS needs approximately $390 additional money and in 2016 it will need an additional approximate $400 million to be actuarially sound, and “this level of contribution will need to be maintained for years to pay off the liability.” Id. Even though under SB 2, the legislature committed to fully funding the KRS, it failed to make any changes to the KTRS. John Cheves, State’s Pension Systems seeking $2.3 Billion in Next Two-Year Budget, HERALD-LEADER, Dec. 5, 2013, http://www.kentucky.com/2013/12/05/2971501/states-pension-systems-seeking.html. The KTRS is considered stable if the state commits to “long-term funding plan” but it is “in danger of being at that tipping point if the contributions do not start coming in.” Mike
IV. Conclusion

Kentucky has managed to effect major changes to some of its pension plans in the face of poor funding ratios that threatened to swamp other budget priorities. At this point it is unclear whether the reforms are deep enough to bring the plans funding levels in line with those of “healthy” states like Wisconsin. 68 It is also unclear whether there is the political will in other jurisdictions to curb costs by moving to defined contribution or hybrid cash balance vehicles. 69 Transparency combined with a fear that pension obligations would soon swamp all other state budget priorities appears to have been the motivating force behind the changes in Kentucky. GASB Statement 68 should put additional pressure on public plans to make clear their financial condition and to adopt expected rates of return that are realistic. As taxpayers learn more about the health of the plans they support and as jurisdictions that fail to make reforms come under increasing pressure and are forced to cut services, one would expect to see additional states with marginal plans commit to significant changes. Changes in plan design—specifically with respect to benefit levels and risk allocation—where politically feasible, should ensure the survival of at least some of the weaker plans.

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68 Wisconsin is the strongest system in the country with a %99.9 funded ratio and a per capita cost of only $18. Berkley, supra note 30, at 2.
69 In Jacksonville, Florida for example, the executive director of that city’s fire and police pension fund has flatly rejected Kentucky-like reforms. “That would not work for public safety officers. We would not be in favor of that. That’s not anything that we would be interested in discussions about for our members.” He is reported to have said. Apparently Mr. Keane (the executive director) believes that the benefits under a DC or cash balance arrangement would be insufficient to “attract talented people to work in the dangerous jobs of police and firefighters.” David Bauerlein, Kentucky Model for Pension Reform Gets Cool Reaction from Jacksonville’s Fund Director, FLORIDA TIMES UNION, September 18, 2013, http://jacksonville.com/news/metro/2013-09-18/story/kentucky-model-pension-reform-gets-cool-reaction-jacksonvilles-fund.