State of South Carolina

Report of the

Government Efficiency and Accountability Review Committee

July 2007

Presented to the Budget and Control Board

Introduction

Changes made to the eligibility rules for our Retirement System earlier this decade combined with generational forces have put the solvency of the entire system at risk. If dramatic changes are not made soon, it may become difficult if not impossible to grant cost-of-living increases to retirees next year. In the medium to long-term, either employee's contributions will have to be increased or the system will end up being a huge drain on our state's General Fund, sucking hundreds of millions or even billions of dollars from other functions of state government.

Because they are in different divisions, the challenges facing the Retirement System and the State Health plan are rarely discussed together. The reality is that they are inexorably intertwined as they both deal with caring for our state's same growing population of government retirees. As the baby boomer generation retires over these next two decades, we are faced with unprecedented fiscal challenges. In addition to the $10 billion in future unfunded health care costs for our retirees, our Retirement System faces an additional $10 billion in unfunded obligations that are recognized and acknowledged.

And neither of those liabilities includes the costs of ad-hoc cost of living increases (COLAs) that have historically been given above the legislatively mandated one percent, which are expected to add another $7 billion in costs in today's dollars. The total potential tab adds up to approximately $27 billion divided amongst 4.2 million citizens of South Carolina. Put another way, that is over $14,000 in costs for every taxpayer in our state.

If we keep our current system as is, the state will have to dedicate approximately $800 million of new funds annually just to keep pace with our unfunded health care and COLA needs. And that number will continue to rapidly grow unless we make changes sooner rather than later.

The unfunded obligations of the Retirement System are expected to increase almost eight fold over the next 35 years. Assuming any increase in our state's assumed rate of return within the next few years would be irresponsible given our performance history. As a result, there seems to be no responsible way to continue funding COLA's above one percent without making immediate dramatic changes to the Retirement system.

We cannot afford more political expediency at the expense of making the difficult decisions. The following recommendations are proposed to begin addressing the critical and mounting problems that face our retirement system:

1) Discontinue Applying Unused Annual Leave and Sick Leave to retirement benefit or length of service
2) Use average of five most highly-compensated years of service to determine average final compensation (ARC)
3) Return to 30 year length of service requirement for normal retirement
4) Closely look at limiting inclusion to our state's defined benefit retirement plan to current employees and only offering a defined contribution plan in the future.

The benefits from the above recommendation include reducing the cost of providing retirement benefits and health care benefits of state and local government employees, improving the funded status of the Retirement System and reducing the Retirement System's unfunded liability.

Recommendation Fifty-Seven
The South Carolina Retirement system should discontinue applying an individual's unused annual leave to increase retirement compensation and should discontinue applying unused sick leave at the time of retirement to creditable service for determining length of service.

Background

The South Carolina Retirement System provides for retirement benefits based on an employee's three most highly paid years of employment. The value of an individual's unused annual leave is currently added to the last year's salary to increase the retirement distribution. Unused sick leave is currently added to an individual's creditable service to determine length of service.

Rationale

Practice among state-sponsored plans varies. For example, in North Carolina, vacation leave may not be used as creditable service for retirement purposes. Unused sick leave may be used to increase creditable service, but cannot be used to meet the minimum qualifications for a vested deferred benefit or the Survivor's Alternate Benefit.

For vested employees, changing the retirement benefit formula may not be practicable. Accordingly, the financial impact of any change would be limited to current non-vested active members and prospective new hires.

Authority for change	First Year Savings
General Assembly	$6,000,000

Savings (three years)
$18,000,000

Recommendation Fifty-Eight
Change the retirement funding formula to be based on an average of the five most highly paid years of employment versus the three most highly paid years of employment.

Background

The South Carolina Retirement System provides for retirement benefits based on an employee's three most highly paid years of employment.

Rationale

Nationally there are thirty other state-sponsored retirement plans that base their average final compensation (AFC) on the five most highly paid years of employment. For vested employees, changing the retirement benefit formula may not be practicable. Accordingly, the financial impact of any change would be limited to current non-vested active members and prospective new hires.

Based on a 4% increase in salary, use of a five year average final compensation for the SCRS results in approximately a 3.75% reduction in future benefits. The impact above does not consider the attractiveness to new hires of the optional DC plan if significant changes to the DB benefit formulas are undertaken.

Authority for Change	First Year Savings
General Assembly	$8,000,000

Savings (three years)
$26,000,000

Recommendation Fifty-Nine
Change the retirement eligibility for new employees back to 30 years.

Background
The South Carolina Retirement System currently provides for full retirement benefits for employees after 28 years of service. Despite ever-increasing life-spans and national trends towards working longer and retiring later, in 2000 the General Assembly reduced the number of work years required to qualify for state retirement from 30 years to 28 years. This change caused an immediate, seven year, $650 million increase to the unfunded liability of our state's retirement system.

Rationale
Clearly one of the biggest factors in pushing our retirement system towards its unstable $10 billion in unfunded accrued actuarial liability was the reduction in the number of years required for retirement from 30 years to 28. The result is that South Carolina's retirement plan generally provides for earlier retirement than most states in the country including our neighbors of Georgia, Florida, North Carolina and Tennessee which all require 30 years of service.

According to a report issued by the SC Chamber in 2000, our move to a 28 year retirement made South Carolina's retirement program more generous than 90% of the nation's major government pension systems.

While generosity is often seen as a virtue, it is not such a good thing when you make such promises with others' money. Unfortunately the taxpayer's are now saddled with a potential growing $27 billion in unfunded costs for retiree's pensions and health care.

In order to address this very serious fiscal problem, we need to at least attempt to stop the bleeding by moving back to a 30 year retirement. For vested employees, changing the retirement benefit formula may not be practicable. Accordingly, the financial impact of any change would be limited to current non-vested active members and prospective new hires.

Actuaries calculate that the first year impact of this change would provide a $4.3 million decrease on the retirement system's unfunded liability and $16.4 million decrease on the annual unfunded liability of OPEB. The ultimate savings would be much more dramatic, as more new members come into the system.

Authority for change	*First Year Savings*
General Assembly	$20,700,000

Savings (three years)
$62,000,000

Recommendation Sixty
A study should be conducted for a plan that limits participation in our state's Defined Benefits System to current employees and only offer a Defined Contribution System for new employees.

Background
The State Retirement System currently offers both a traditional defined benefits plan and an optional plan which is a defined contribution plan. The defined benefits plan guarantees a one percent cost of living increase for participants as of last year. The plan is currently under-funded by approximately $10 billion dollars, which is near its 30 year liability limit.

Rationale
The impending retirement of the baby-boom generation and longer life expectancies have caused most private sector retirement plans to switch to more economically-stable defined contribution plans. In fact, only 17% of workers in the private sector still have a traditional defined benefits plan.

In spite of the widely-held view that government jobs need higher benefits to make up for lower pay, USA Today recently reported that "*most government workers are actually paid more than private employees in similar jobs*, and the wage gap is growing. A typical full-time state or local government worker made $78,853 in wages and benefits in the third quarter of 2006, $25,771 more than a typical private-sector worker, the Bureau of Labor Statistics reports. The difference was $7,604 in 2000."

The federal government foresaw the coming fiscal crisis and reacted by closing its traditional defined benefit plan *to new employees in 1984 when it offered its first defined contribution plan. The state of* Alaska recently adopted a mandatory defined contribution plan for all new state employees as a way to stop the bleeding on its retirement systems $6 billion unfunded liability.

The primary reasons for moving to a defined contribution plan is a need to reduce cost and future funding liabilities, a desire to reduce the golden handcuffs that make it difficult for a worker to change jobs, and a desire to *allow greater fund accumulation* for shorter service workers.

The fiscal impact to the state will depend on the contribution rates of the defined contribution plan that the state decides to offer. Unlike our current defined contribution, the liabilities will be fixed so that taxpayers will only be forced to pick up the tab for one $20 - $27 billion shortfall rather many more of them in the future.

Authority for Change
General Assembly