Rhode Island Plan Enacts New Approach to States' Pension Woes

Faced with rising pension costs, Rhode Island passed a set of reforms to its public sector retirement system that go further than what any other state has done. The bill is unprecedented, both in terms of the employees it will affect and the scope and scale of changes to their benefits. Advocates of the reforms claimed they are needed to curb expanding costs that, left unaddressed, could have had severe impacts on state finances and taxpayers. Opponents, including unions, claimed the measures went too far and put workers' retirement security at risk.

To narrow an estimated $7 billion shortfall, the Rhode Island Retirement Security Act (RIRSA) of 2011 altered the pensions of current workers and retirees—not just those of new hires, as has occurred or been considered in many other states. The bill limits cost-of-living adjustments until the retirement system improves; reduces the ability of all employees, old and new, to earn additional pension benefits; raises the state's retirement age for a new employee to 67; and shifts some of the risk of investment losses from the state to employees and retirees. The new rules will go into effect on July 1, 2012.

Rhode Island's public sector retirement benefit systems, for both the state and many of its cities, are in deep trouble. Last August, mounting pension costs spurred the town of Central Falls to file for bankruptcy. As of fiscal year 2010, the state had only 49 percent of the money needed to cover its pension promises, far less than the 80 percent most analysts recommend. Rhode Island and Illinois are the only states with funding rates under 50 percent, based on the most recently available data. The RIRSA, introduced in mid-October by state Treasurer Gina Raimondo (D) and Governor Lincoln Chafee (I), cuts Rhode Island's unfunded liability. An actuarial analysis of a previous version of the bill concluded that it would reduce the funding shortfall by about $3 billion.

How will the new rules affect current and new state employees?

Rhode Island is the first state to change core benefits for current employees. Its constitution—like that of many other states—prohibits it from unilaterally altering contracts. Unions have threatened to sue to roll back the enacted reforms.

Following passage of the RIRSA, Rhode Island follows at least six other states—such as Georgia and Utah—in putting new employees in a hybrid plan. But it is the first to incorporate current employees as well. A hybrid plan combines features of defined benefit and defined contribution plans. In a defined benefit system, the government promises to pay a certain amount each year once an employee retires for the rest of the employee's life. In a defined contribution system, the government promises to set aside a certain amount of money in an employee's retirement account but does not make any promises about how much the employee will have post-retirement.

Previously state employees contributed 8.75 percent of their pay to the defined benefit plan; teachers paid 9.5 percent. Now they will contribute 3.75 percent to the defined benefit component and 5 percent to the new defined contribution account. The state will contribute an additional 1 percent to employees' defined contribution accounts, on top of the defined benefit. (Teachers and public safety workers who are not in Social Security get a more generous employer match.) While the state now actually will pay a higher share of new benefits for employees going forward, its liability was reduced because the overall cost of the benefits package went down.

Under the new rules, the defined benefit component provides a 1 percent a year multiplier. For example, the annual retirement benefit for a state employee who has worked 30 years would be 30 percent of his or her final salary. The old plan used a higher multiplier.

This means that current workers are able to keep the retirement benefits they have accumulated already, but moving forward, they will earn new benefits at a lower rate. The reduced defined benefit under the new plan is supplemented by the employee's defined contribution account. Those who want to collect any additional defined—i.e., pension—benefits accumulated in the hybrid plan will have to serve until they reach the full retirement age, which is later than under the previous set of rules and varies by age and length based on age. (Employees could collect savings accrued through the defined contribution component regardless of when they retire.)

Similarly, new employees will qualify for full pension benefits only if they work until they reach Social Security eligibility—67 years old.

The new pension rules also change how employees accumulate retirement benefits. Under the previous system, workers gained pension wealth slowly at the beginning of their careers, earn benefits as they approach retirement age, and then experience a decline in pension wealth if they keep working. As a result, some workers have been dissuaded from entering the public workforce while experienced employees have been encouraged to retire early. The new plan allows workers to earn their benefits more smoothly over time and avoid experiencing such a drop in pension wealth.

Finally, the RIRSA will result in both current and new employees sharing more of the investment risk that the state had previously assumed. If a future recession causes steep investment declines, both employees and the state would take losses.

How will the new rules affect retirees?

For the time being, the changes sharply limit the annual compounded cost-of-living adjustment (COLA) offered to retirees. Rhode Island will only give a COLA once every five years as long as its pension plan funding level remains below 80 percent. If the state returns to the 80 percent threshold, it would reinstate a COLA as an annual increase. New COLAs will be based on investment returns rather than being a fixed 3 percent, and apply only to the first $35,000 in benefits, adjusted for inflation.

Historically, states have been reluctant to alter COLAs because of concerns that courts might classify them as legally protected benefits. That changed in 2010 when Colorado, Minnesota, and South Dakota froze, reduced, or eliminated their COLAs, and lower court judges upheld the new limits in Colorado and Minnesota. (South Dakota's changes are still under review.) In 2011, Maine, New Jersey, Oklahoma, and Washington followed suit; New Jersey and Washington now are facing legal challenges.

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