



**Ohio
Retirement
Study
Council**

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To: Chairman Carfagna
From: Jeffery A. Bernard, Senior Research Associate *JAB*
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Subject: Intergenerational Equity and STRS

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Summary

When evaluating any legislative action, the staff of ORSC are required to conform and balance their analyses to certain "principles governing pensions" and prior precedents (in the form of ORSC recommendations and passed laws). One foundational principle that is often referenced in ORSC staff analyses is the concept of *intergenerational equity*. This is the idea that each generation is to fund its own retirement benefits. This memo provides a brief explanation of this concept and its application to the State Teachers Retirement System.

Principles Governing Pensions

The "Principles Governing Pensions" are the principles that the ORSC is expected to observe and follow in its review and recommendations related to the benefits of the state retirement systems. These principles are longstanding controls that ensure that there are not wild swings in benefits or governing of the state's pension systems.

Most recently updated in 1978, D.3 of the "Principles Governing Pensions" states in part that "there should be equal treatment in the burden of pension financing between generations of taxpayers." This is known as intergenerational equity. The idea is that each generation (employees, employers, and taxpayers) provide sufficient funding as the benefits are earned to pay for future pension benefits (a detailed, technical explanation of this funding is provided in the ORSC issue brief

“Unfunded Accrued Actuarial Liability and its Amortization”).¹ The ideal situation is that no generation pays more or less than is necessary to fund their own generation’s benefit, with any unfunded liabilities being paid over time by employer contributions.² Its application in law is that a retirement system cannot push its funding beyond 30 years without being required to submit a plan to reduce its funding period below 30 years.³

Governing and Financing Basis of Intergenerational Equity

There is both a governing philosophy and a financing practicality to the intergenerational equity standard.

The governing philosophy is that those who benefit from a service (in this case some sort of government service) are also the ones who pay for it (through taxes, employee and employer contributions). A 100% funded system with \$0 unfunded liability is one where current generations are successfully paying for their own benefits. If this principle is not followed (if a system is less than 100% funded), costs for current services are pushed onto future generations, who then must either cut benefits or raise contributions to pay for a previous generation’s services. Intergenerational equity provides that the state’s retirement systems apply the same governing philosophy as the state itself, which constitutionally must balance its budget rather than issue debt.

There is also a financing practicality to the intergenerational equity standard. Providing retirement benefits to the state’s employees is extraordinarily expensive. Each year, the state’s five retirement systems pay out approximately \$17 billion to the system’s retirees and beneficiaries. To put this in another context: the annual state budget is roughly \$70 billion, meaning that the benefits paid out by the systems annually is equivalent to roughly 25% of the state’s entire budget. This is an enormous sum of money that the systems must continually fund, regardless of investment returns or contributions to the systems.

This \$17 billion annual benefit is nowhere close to what the five systems receive annually in contributions (from employees and employers). For instance, STRS receives annually, as contributions from employers and employees, approximately \$3.1 billion.

¹ <http://orsc.org/Assets/Reports/1368.pdf>

² ORSC, “Principles Governing Pensions,” D.1.

³ R.C. 145.221, 742.16, 3307.512, 3309.211, and 5505.121.

STRS pays out in the same period \$7.2 billion;⁴ therefore STRS must invest contributions over a long period of time if it has any hope of paying benefits in the future. ORSC staff note that this model is the exact opposite of Social Security, which simply transfers funds from one generation to the next—the state retirement systems are *saving* and *investing* for retirement rather than relying on future wealth transfers to retirees. If the systems did not save and invest, providing benefits would require contributions by employees and employers to increase markedly, putting enormous strain on local and employee budgets. The good news is that investments can make up the difference. The bad news is that if the principle of intergenerational equity is not followed, the funding system will break down quickly.

As an analogy, consider a farmer saving seed corn for next year's planting. Without saving sufficient seed corn, the farmer will have to purchase new corn for planting the following year—this is analogous to Social Security's funding model. However, with a disciplined setting aside of seed corn, the farmer can grow his crop indefinitely. What the retirement systems are doing is analogous to this except on a much grander and ambitious scale. Indeed the farmer is setting aside seed corn each year, but the farmer is also setting aside each year whatever that seed corn produces to create a massive reserve. Intergenerational equity is the idea that, while the farmer is saving and investing his seed corn, no other farmers are allowed to raid it for their own use.

State Teachers Retirement System

The generation to which current STRS retirees belong did not adequately fund the benefit they are receiving; the current generation of active employees, employer, and taxpayers are paying that bill. This happened for a number of reasons, including changes in assumed investment return, expansion of benefits, and changing life expectancy.

There are a number of different ways to measure this disparity, but one of the most direct is the "normal cost." Normal cost is an actuarial term referring to the steady level of contributions over an active member's career necessary to fund projected benefits. Current members pay a higher normal cost (contributions) to STRS than is necessary to fund their own benefits. The contribution necessary to fund current active employees' benefits is projected to be 10.86% of their pay. Yet, STRS members pay 14% of their pay,

⁴ State Teachers Retirement System of Ohio: Actuarial Valuation Report as of June 30, 2020, 23.

meaning that 3.14% of teacher's pay is being diverted to retirees. Additionally, each employer pays an amount equal to 14% of a teacher's pay. This contribution does not accrue to the employee's benefit, instead being diverted to pay for retiree unfunded liability. This means that an amount equal to 17.14% of a teacher's pay is being *redirected away from the current generation to the retirees*. The diversion of the 3.14% of active member's pay is a particularly direct violation of intergenerational equity —the current generation of workers is explicitly and directly paying for benefits earned by another generation of workers, employers, and taxpayers.⁵ No other state retirement system has a negative normal cost.⁶

Unfortunately, a negative normal cost is necessary, as STRS has and is providing benefits to retirees that were *not adequately funded by those retirees*. Current retirees did not sufficiently fund their current base benefit, let alone further unfunded COLA increases. The COLA suspension is, therefore, necessary to avoid ever further increases in unfunded liabilities that will have to be paid for by the current generation of workers. In fact, according to the Principles Governing Pensions, the current situation would suggest that improvements in STRS funding first be realized in reducing employee contributions to be closer to the 10.86% normal cost than to grant additional unfunded COLA increases for current retirees.

⁵ For comparison, the normal cost in 2000 was 15.3% and in 2010 it was 14.3%. Employee contributions during this period were 9.3% and 10%, respectively.

⁶ According to the most recent actuarial valuations of the state retirement systems, STRS is the only system with a negative normal cost.