



Ohio Retirement Study Council

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To: Chairman Carfagna, 2021/Chairman Romanchuk, 2025
From: Jeffery A. Bernard, Senior Research Associate
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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 (STRS).

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 Practicality 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. In FY2022, the state’s five retirement systems paid out approximately \$17.2 billion to the system’s retirees and beneficiaries. To put this in another context: HB 33 (the Main Operating Budget) provides \$41.4 billion in state and federal General Revenue Fund appropriations for the state’s FY2024 operating budget.⁴ Annual benefit payments provided by the retirement systems are an enormous sum of money that the systems must continually pay, regardless of investment returns or contributions to the systems.

This \$17.2 billion annual benefit is nowhere close to what the five systems receive annually in contributions (from employees and employers). For instance, in FY2023 STRS received, as contributions from employers and employees, approximately \$3.8

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

² ORSC, “Principles Governing Pensions,” D.1 and D.3.

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

⁴ <https://www.lsc.ohio.gov/assets/legislation/135/hb33/en0/files/hb33-budget-in-brief-as-enacted-135th-general-assembly.pdf>.

billion⁵ and STRS paid out \$7.2 billion;⁶ 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 is designed as an anti-poverty program and 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 base 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 returns, 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' defined plan benefits is projected to be 10.93% of their pay.⁷ Yet, these STRS defined

⁵ 2023 STRS Annual Comprehensive Financial Report, pg. 6. (available online at: <https://www.orsc.org/Assets/Reports/1598.pdf>).

⁶ Ibid, 15.

⁷ This normal cost figures excludes combined plan participants, who have a different employer and employee allocation.

plan members pay 14% of their pay, meaning that 3.07% of teacher's pay is being diverted to address a previous generation's unfunded liability.⁸ 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 17.07% of a teacher's pay is being *redirected away from the current active teacher's generation to fund a previous generation's debt*. The diversion of the 3.07% 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.⁹ No other state retirement system has a negative normal cost.¹⁰

Unfortunately, a negative normal cost is necessary, as STRS has and is providing benefits to retirees that were *not adequately funded by that generation*. The retirees' generation 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 10.93% normal cost than to grant additional unfunded COLA increases for current retirees.

⁸ State Teachers Retirement System of Ohio Actuarial Valuation Report as of June 30, 2023, pg. 3 (available online at: <https://www.orsc.org/Assets/Reports/1595.pdf>).

⁹ For comparison, the normal cost in 1998 was 15.3% and in 2012, immediately prior to pension reform, it was 15.7%. Employee contributions during this period were 9.3% and 10%, respectively. (Ohio Retirement Systems: 1998-2022, ORSC Staff Report on the Historical Experience of the Five Ohio Retirement Systems Since 1998, pg. 68 (available online at: <https://www.orsc.org/Assets/Reports/1606.pdf>).

¹⁰ According to the most recent actuarial valuations of the state's retirement systems, STRS is the only system with a negative normal cost in Ohio. More broadly, although there are some tiers in retirement systems with a negative normal cost, ORSC staff are not aware of any other state level system with a negative normal cost in the United States. (See Wisconsin Legislative Council, "2020-21 Comparative Study of Major Public Employee Retirement Systems," pg. 21-22 and "Pension System Comparison" February 15, 2024, presentation to the STRS Board (available online at: https://www.strsoh.org/pdfs/board/meeting_materials/2024/February/pension-system-comparison.pdf).