ARIZONA CHAMBER FOUNDATION

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MODERNIZING TEACHER PENSIONS FOR THE 21ST CENTURY

An Arizona Chamber Foundation Policy Brief

INTRODUCTION

The Arizona State Retirement System (ASRS) is a defined benefit retirement plan that covers most state and local government employees, including public school teachers in all district schools and in any charter schools that opt into the system. Designed more than a half century ago to suit a vastly different economy, there is no mistaking the negative trends in Arizona's pension system covering teachers and state workers. Just two decades ago the pension system that covers Arizona's teachers (in addition to state workers and others) was thriving and teachers contributed only a modest amount of their paychecks for the promise of a healthy retirement payout. Today, we see a pension system in decline and a much heavier burden placed on teachers and school systems. Analysts from both the libertarian Reason Foundation and the progressive Urban Institute have sounded the alarm over the financial problems of ASRS. Those problems have also created substantial difficulties in the ability of Arizona schools to operate, squeezing money out of the teacher's pockets and classrooms. This problem could worsen if Arizona does not take steps to modernize this declining system.

Arizona's pension system for teachers has not yet reached the precipice of complete desperation, but it is trending in that direction. Worse still, the status-quo of Arizona's pension system covering teachers damages a school's ability to attract and retain teachers due to the quadrupling of a teacher's contribution, even while a funding shortfall has ballooned.

Despite the pension system's current challenges, Arizona lawmakers have the benefit of a more positive home-grown experience with pension reform that can serve as a helpful road map in navigating ASRS modernization.

In 2016, Arizona Gov. Doug Ducey signed into law comprehensive pension reform legislation to put Arizona's beleaguered public safety pension system on a path to financial solvency. The Arizona Public Safety Personnel Retirement System (PSPRS)—which covers all law enforcement personnel and firefighters statewide—had accumulated $6.6 billion in unfunded liabilities and stood at only 48 percent funded. Then state Senator (now United States Congresswoman) Debbie Lesko spearheaded the effort, which included a broad coalition stretching from public sector unions to libertarian thinktanks. If there is one thing to be gleaned from Arizona's recent successes in pension reform, it is that coalition-building and consensus are key.

The pages ahead will not make specific suggestions for reforming ASRS. That is best left to a collaborative process of the sort achieved with PSPRS. Rather, our present purpose is to reveal the enormous and unsustainable educational costs mounting under the status-quo. Arizona's system of pensions for public school teachers faces soaring costs and growing deficits and requires modernization.

THE ARIZONA STATE RETIREMENT SYSTEM

Arizona lawmakers created ASRS in 1953 in order to provide retirement benefits to state employees.[1] Arizona teachers originally belonged to a separate retirement system, but voted to join ASRS in 1954.[2] In 1970, Arizona lawmakers created the Defined Benefit Plan to which most state workers and teachers contribute today.[3] ASRS currently covers state workers, employees of all three public universities, school districts and participating public charter schools, employees of most cities and towns, and the employees of several special districts.[4] In 2018, ASRS paid out $3 billion to approximately 142,000 retirees. ASRS covers another 210,000 employees and 233,000 inactive plan members who no longer work in the public sector in Arizona, but who are entitled to future benefits based on their past service.

ASRS uses the following basic formula to calculate the retirement benefit:

Benefit = Multiplier × Years of Service × Final Average Salary[5]

The multiplier is a percentage set by the state, years of service is the number of creditable service years that an employee has earned upon separation, and final average salary (FAS) is the average salary earned by an employee over the last few years of his or her career.[6]

The Arizona Chamber Foundation published a paper called *Pension Tension: Understanding Arizona's Public Employee Retirement Plans* in June 2010. Even in 2010, precipitous increases in employer contribution rates foreshadowed present challenges:

> *The financial position of ASRS has weakened significantly over the past decade. The plan currently has a $7.4 billion UAAL (unfunded actuarial accrued liabilities) just ten years removed from a $3.6 billion surplus. As a result, the employer contribution rate (the taxpayer contribution to the public pension plan) has risen to 9.6%.[7]*

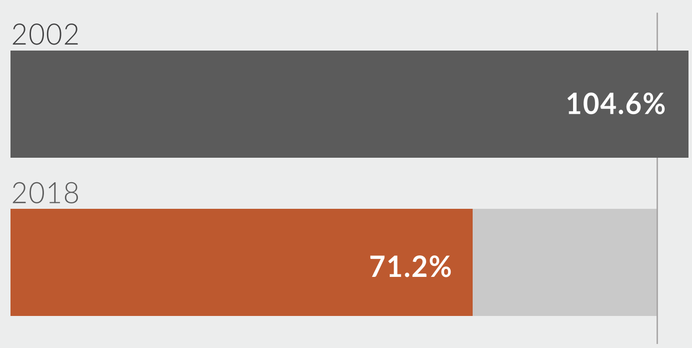
Today, the viability of ASRS is even more precarious. The funding status slipped from 79 percent to 71 percent and the funding shortfall more than doubled despite increasing contribution rates between 2002 and 2018.[8] Pension analysts from both the right and the left have sounded the alarm concerning the current state of the ASRS.

INCREASES IN REQUIRED CONTRIBUTION RATES IMPACT TEACHER PAY

The increase in required ASRS contributions from both teachers and schools over the past two decades has reduced Arizona teachers' total take-home pay.

By 2002, ASRS had amassed a billion-dollar surplus and had 104.6 percent of funds needed to fund beneficiaries, despite taking a modest 3 percent of payroll from ASRS participants and another 3 percent of payroll from the employer. (See Figure 1). Starting in July of 2019, the system

FIGURE 1
Arizona State Retirement System Funded Ratio 2002 and 2018 (Source: Reason Foundation)

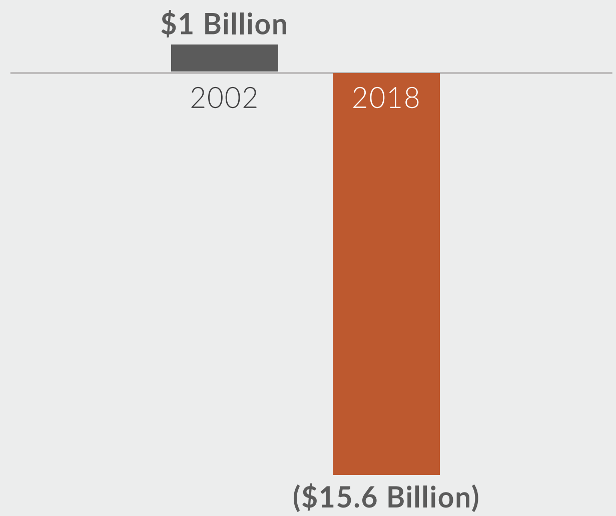


will have increased the burden on classroom teachers, taking 12.11 percent directly from teachers and other contributors and another 12.11 percent from teachers' schools.[9]

Taking into account the total required teacher and employer contributions, the 2002 ASRS contribution rates amounted to, in effect, a 6 percent tax on teaching. Starting in July of 2019, the system has ballooned to a *de facto* 24.22 percent tax on teaching payrolls (12.11 percent funded by a teacher's gross salary and another 12.11 percent funded by the school system).[10] As shown in Figure 1, the solvency of the system has continued to decline *despite* this large contribution increase.

The Pension Integrity Project at the Reason Foundation estimated the ASRS funding shortfall to be $15.6 million in 2018. (See Figure 2).

FIGURE 2
Arizona State Retirement System–Surplus and (Deficit) 2002 and 2018 (Source: Reason Foundation)



The Reason analysis lays out a variety of risks facing ASRS.[11] The Urban Institute, a group on the opposite end of the ideological spectrum from the Reason Foundation, examined ASRS finances and reached broadly similar conclusions:

> *Under current benefit rules and contribution levels, the plan actuaries calculate that the system now holds enough funds to cover only 71 percent of future benefit obligations (ASRS 2017b).The plan's true financial situation is likely even worse, because these calculations are based on overly optimistic assumptions about how much the plan assets will earn over time. Unless lawmakers reform the state pension system, this deficit will force them to raise plan contributions, necessitating higher taxes or the diversion of scarce resources from other pressing state priorities.*[12]

The challenges facing ASRS do not spring from a single source, but several legislative decisions contributed to the current status along with other factors. The 2010 Chamber Foundation study[13] listed the following factors as contributing to the difficulties in ASRS:

- Increases benefit multipliers in 2000 and 2001
- Increased health insurance medical benefit
- Increase in the cost of living adjustment
- Changes in age restrictions for cost of living adjustments
- Decreased threshold of determining "excess earnings"
- Removal of a cap on the maximum benefit size as a percentage of salary at 80 percent.

Many states increased the generosity of their public pension programs during the "dot-com" stock market bubble during the late 1990s and early 2000s.[14] Almost two decades later, the status-quo of these programs is unsustainable. More subtly, however, the increased need for funds in these programs has increased difficulties within the public education system.

Quadrupling the direct rake off out of teacher salaries from 3 percent to 12.11 percent reduced net teacher take-home pay. However, the 12 percent of payroll contributed out of school budgets also drains coffers of funds that could otherwise be used to pay teachers. In other words, the required employer contributions sent to ASRS by districts and charter schools cannot be allocated for other purposes—including increasing teacher pay.

An old expression holds that if policymakers want more of something, they subsidize it, while if they want less of it, they tax it. There can be little doubt that the decreased take-home pay resulting from the increased employee and employer contributions to ASRS has decreased the willingness of people to enter the teaching profession. The prospective first-time teachers of today are being asked to enter a profession with diminished take-home pay in return for participation in a pension fund with declining solvency. The recent increases in state revenues providing the funds for a 20 percent increase in teacher pay by 2020 will counteract the squeeze placed on teacher take-home pay, but the ASRS system may undo this progress in future years absent timely modifications in ASRS.

RECENT ASRS REFORMS

In 2011, Arizona Governor Jan Brewer made several changes to ASRS by signing Senate Bill 1609, which changed the laws governing ASRS benefits for teachers and other enrollees hired on or after July 1, 2011. Under previous law, all teachers could collect full benefits at age 62 if they had 10 or more completed service years or at age 65 if they had fewer service years, or if they satisfied the "Rule of 80," which requires that their age and service years total at least 80. Under the Rule of 80, a teacher with 25 years of service could retire and collect full benefits at age 55.[15]

Under SB 1609, new hires could not collect full retirement benefits unless they satisfied one of the following four criteria: Reached age 65; reached age 62 with 10 years of service; reached age 60 with 25 years of service; or reached age 55 with 30 years of service. In addition, the 2011 legislation changed the amount of money that teachers leaving ASRS could withdraw. Teachers hired before 2011 can choose the "enhanced option," which allows them to withdraw their personal contributions plus employer contributions along with interest. Teachers with at least 10 years of service could withdraw 100 percent of employer contributions. However, the enhanced option is no longer available to teachers hired after 2011.[16] SB 1609 attempted to make changes to cost of living adjustments (COLA), which were subsequently challenged and reversed by the Arizona Supreme Court.[17]

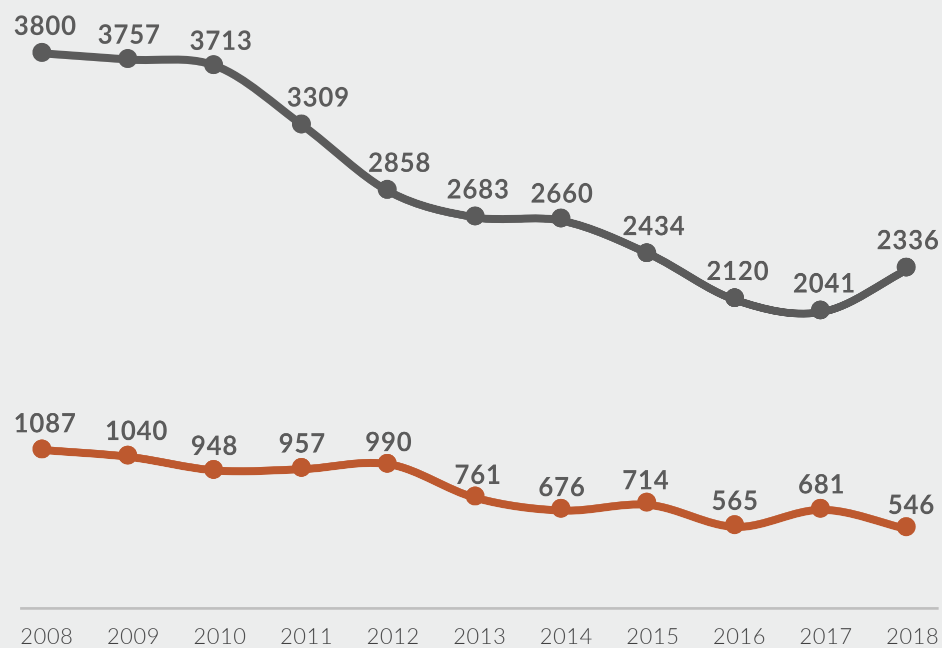
Despite SB 1609, the net impact of the changes to the pension system since 2000—in both increasing and tightening the generosity of the system—has been that the ASRS funding shortfall and required payments from teachers and schools have continued to grow. The shortfall has expanded despite teachers and schools paying four times more than they did in 2002.

ARIZONA'S TEACHER SHORTAGE

Young people are choosing to avoid the teaching profession at higher rates than previous generations. Policymakers should be exploring why that is the case, and more importantly what they can do about it. Modernizing teacher pensions to make the profession more attractive represents an opportunity to reverse the trend.

Nationally, traditional undergraduate teacher training programs have experienced a pronounced decline in enrollment in recent years. In the 1970s, American universities peaked in producing over 200,000 education degrees, but today this stands at less than 100,000 per year.[18] Arizona has not been immune to this trend, and in fact, the number of undergraduate degrees conferred by the state's largest teacher's college, Arizona State University (ASU), fell by almost half between 2008 and 2018. As shown in the data, ASU has experienced a substantial decline in both enrollment and the number of graduates produced per year.[19] (See Figure 3)

FIGURE 3
Arizona State University Teachers College Undergraduate Enrollment and Graduations 2008 to 2018



State officials and ASU officials took action to increase enrollment and graduation through the Arizona Teachers Academy program,[20] which covers tuition for students who agree to teach in an Arizona public school equal to the amount of years a scholarship was used. Arizona's fiscal year 2019 state budget included an appropriation of $15 million to the program with the goal of increasing undergraduate and master level degrees leading to initial teacher certification by 1,000.[21]

The scale of the problem shown in Figure 3 becomes clearer, however, when you consider the fact that ASU undergraduate enrollment increased by over 36,000 students during this period. In 2008, 7.1 percent of ASU students attended the Teachers College. By 2018, this had dropped to 2.5 percent.

Arizona is not now, and has not been for a very long time, dependent solely on freshly minted education undergraduates to fill available teaching positions. Nevertheless, the trend generates concern.

Arizona district and charter schools hired 8,625 new teachers in 2014, but the education colleges at the University of Arizona, ASU and Northern Arizona University produced a combined 1,497 graduates with Bachelor of Arts degrees. This means that Arizona schools must avail themselves to several sources of teachers other than newly minted undergraduates: teachers from out of state; teachers from alternative certification programs; or former teachers returning to the profession. Fortunately, research from the Brookings Institution has demonstrated that teachers from alternative certification paths show equal effectiveness in producing student learning gains.[22]

While alternative pathways to the classroom represent sound practice, such pathways will prove of limited utility if all categories of prospective teachers (traditional or otherwise) eschew the profession. Rather than the cause of the shortage, the decline in enrollment at Arizona teacher colleges is better characterized as a concerning leading indicator. In other words, the precipitous decline in enrollment shown in Figure 3 above should thus be viewed as a symptom of a problem rather than the problem itself.

HOW ASRS CONTRIBUTES TO TEACHER SHORTAGES

The Urban Institute's analysis of ASRS posited a link between the state of the pension system and the difficulties faced by Arizona schools in recruiting and retaining teachers:

> *Because members hired at age 25 must work well over a decade before their pension benefits exceed the value of their own contributions, those who separate earlier receive no employer-funded retirement benefits for their years of service. Despite offering generous benefits for long-term service as a way of persuading new hires to stay on the job, Arizona has struggled with low teacher retention rates that have been blamed on everything from low pay to reduced education funding. According to withdrawal rates from 2017, most new employees hired by ASRS end up leaving the job within six years. They thus miss out on a large portion of the benefits earned by long-term workers, given the vesting period of five years.*[23]

The Urban Institute analysis may have, in fact, understated the role of pensions in teacher shortages. Vanishingly few if any undergraduates pursue the details of state pension policies before declaring their major—but they needn't do so to be deterred from entering the teaching profession. Undergraduate students can be deterred from entering the teaching profession simply by an awareness that teachers don't get paid well. The increased required contribution from ASRS contributes to lower teacher take-home pay.

By reducing take-home pay, the pension system can deter teacher recruitment efforts even if prospective teachers lack awareness of details regarding factors constraining take-home pay. In other words, prospective teachers don't need to understand that pensions absorbing a large portion of payrolls contributes to a lower teacher pay—they may be deterred simply because they believe it is low. Arizona lawmakers have aggressively addressed teacher pay with additional state revenue, but the possibility of increased pension contributions poses a risk to the sustainability of these increases to actual take-home pay.

If prospective teachers *did* dig into the details of ASRS, even fewer might choose to pursue an education degree. ASRS participants must stay in the system for a decade in order to be completely vested in the benefits including employer contributions, but the average employee covered by ASRS leaves the system after six years. Strikingly, only 30 percent of ASRS participants reach the 10-year mark.[24] As a result, the average teacher forgoes pay (the required employer contribution), but receives no corresponding pension benefit.

ASRS participants leaving before five years of service receive none of the employer contributions. Fully vested ASRS beneficiaries in effect draw a large subsidy from employees who remain in a position for less than five years.[25] After five years, an ASRS participant vests in 25 percent of the employer match, increasing incrementally before reaching 100 percent at 10 years of service. As the Urban Institute summarized:

> *These early leavers will receive their own plan contributions with interest back, but most of them will not gain anything at all from the regular pension benefits of ASRS, which have a vesting period of five years. The results shown here include other state employees besides teachers, but they are nonetheless indicative of the major problems that Arizona has experienced with teacher retention rates over the past decade.*

ASRS, in short, is built for an era in which people signed on with an employer, worked in a multi-decade career with the same organization, and then retired. This does not typify the modern American labor market in general, nor the current teaching profession. Arizona schools today must continually search for new teachers. A pension system availing itself to a large percentage of total school payroll makes recruitment difficult since it puts a much lower ceiling on how much schools can give them in take-home pay. Arizona schools must continually search for new teachers. Pension reform could play a role in helping schools to find the teachers they need.

ARIZONA HAS TIME TO ADDRESS A PROBLEM BEFORE IT BECOMES A CRISIS

The current difficulties are occurring during a 10-year bull market in American stocks and (at the time of this writing) record highs in American indexes.[26] The Urban Institute provides a dire warning regarding the consequences of less favorable future scenarios:

> *ASRS continues to face serious funding challenges. Our simulations show that if the investment assumptions of the plan actuaries materialize, ASRS could reach a healthy funding ratio without any substantial alterations to the current level of employer contributions. However, more realistic actuarial and investment scenarios indicate that the annual employer contributions required to fully fund the plan must double or nearly triple over current levels. If one of these scenarios ends up materializing instead, ASRS would require substantial amounts of additional taxpayer funds to reach a strong financial status.*[27]

Plausible scenarios whereby the system goes into deep crisis have been laid out in detail by pension analysts of both the right and left. These can and should however be prevented.

Economist Herbert Stein sagely noted what came to be known as “Stein’s Law” which reads as follows: “If something can’t go on forever, it will stop.”[28]

Arizona has been asking this generation of teachers and schools to pay an increasingly heavy burden for the previous generation of teachers. Despite the quadrupling of required contributions to ASRS, the system’s shortfall has continued to grow. Not entirely coincidentally, Arizona public schools have faced increasing difficulties in recruiting teachers. In addition, it is easy to imagine market conditions less favorable than those of the previous decade in the years ahead. ASRS, in short, requires modernization.

Arizona’s teacher pension system cannot go on forever taking a growing bite out of teacher paychecks while simultaneously presiding over a large and growing funding shortfall. The sooner this unsustainable trend stops, the better. It’s not too late to turn these trends around, and Arizona has a recent positive experience to build upon in pension modernization with regards to public safety officers. What’s more, Arizona need only look to Kentucky for a cautionary tale to understand the importance of timely reform and carefully towards modernization of ASRS.

After decades of neglect, Kentucky lawmakers attempted to slip through hastily assembled pension reform legislation without efforts to consult with stakeholders, the public, or a normal legislative hearing process. Despite a clear crisis, the Kentucky effort did not go well for anyone. Teachers went on strike, bitterness ensued and, while the reform effort passed, the measure was thrown out in court. Kentucky’s pension system remains essentially insolvent, thus sending out the funds it receives to pay current beneficiaries without investing the funds necessary to provide for future beneficiaries. Kentucky provides not only a cautionary tale for Arizona, but also a detailed lesson in how *not* to pursue pension reform.[29]

Arizona's business community has a stake in the success of the public education system, including the modernization of the pension system. Broad communities of interest however must reach a consensus on reforms in order to protect the interests of pensioners, teachers, students, and taxpayers.

It's not too late to act. Delay will only result in a worsening of the situation from both a pension solvency and an education standpoint. The purpose of this paper was modest but important—not to suggest any particular solution, but rather to impress upon the appropriate stakeholders the urgent need to develop one. In the words of the closing-time expression: "*You don't have to go home, but you can't stay here.*"

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