



Fiscal Policy BRIEF

September 1995

An Update on Teacher Retirement Funding in Indiana

While prevailing wage, welfare reform, and auto excise tax reductions shared center stage throughout the 1995 legislative session, one of the most significant legislative initiatives enacted by the 1995 General Assembly went all but unnoticed. Proposed by the governor and approved by legislators with strong bipartisan support, a new dedicated fund, the Pension Stabilization Fund, was created to address the rapidly escalating demand on state resources posed by the unfunded liability in the Teachers' Retirement Fund (TRF). Though previous steps have been taken to address the poor financial condition of the TRF, the Pension Stabilization Fund represents the most significant legislative attempt to address the unfunded liability, which currently exceeds \$6.5 billion.

Background of TRF Reform

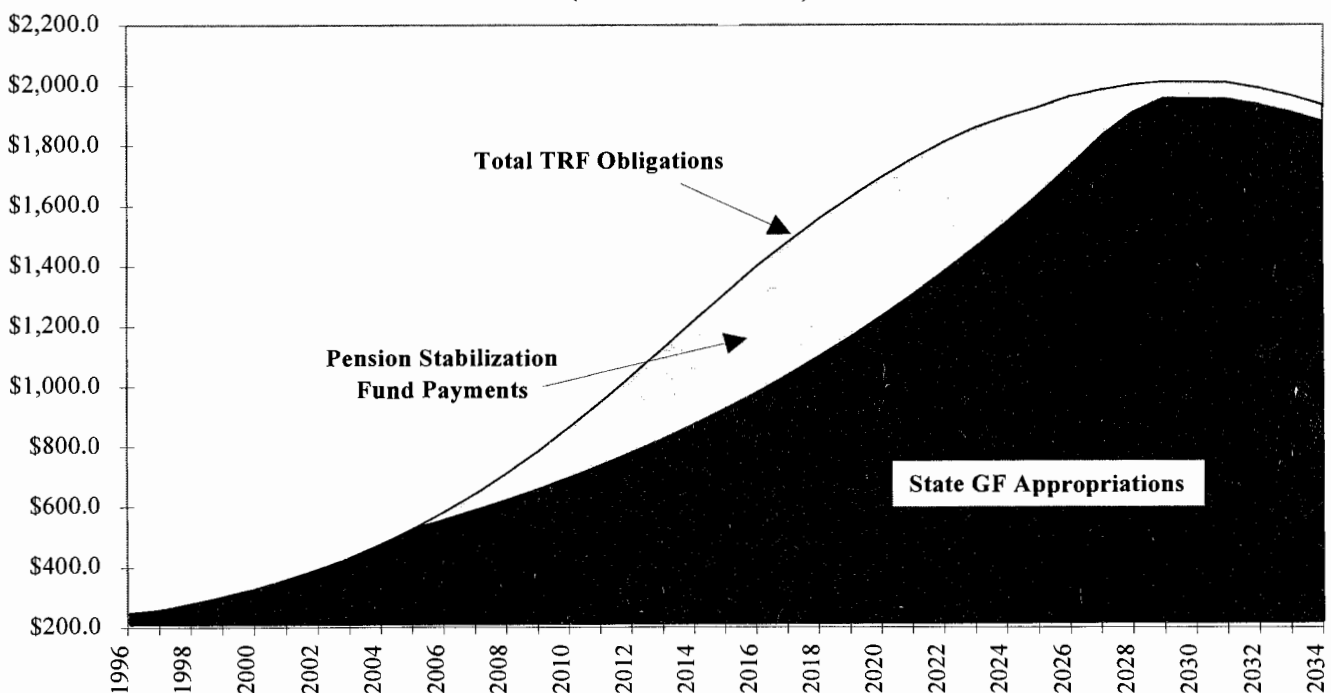
Following a report of the Indiana Fiscal Policy Institute (*Indiana Public Employee Pension Funding*, March 1993), the 1993 General Assembly enacted legislation which closed the

teachers' pay-as-you-go retirement plan (pre-1996 plan) and established a new fully-funded plan for teachers hired after June 30, 1995. Unlike the pre-1996 plan, the new plan incorporates an advanced funding mechanism that requires school corporations to set aside a level percent of payroll funding for all newly hired teachers to cover retirement benefits as they are accrued. Though this step is projected to save the state approximately \$12 billion in General Fund (GF) expenditures over the next 45 years, the creation of a fully-funded retirement plan for newly hired teachers fails to address the large and growing unfunded liability in the pre-1996 plan.

The Problem: Pay Now or Pay Later

Since the pre-1996 plan is funded by legislative appropriations on a pay-as-you-go basis, and with the membership in the pre-1996 plan totalling approximately 93,000 members (65,000 active and 28,000 retired), state GF support for TRF

Figure 1
Total Teachers' Retirement Fund (TRF) Obligations*
State of Indiana, FY 1996 to FY 2034
(dollars in millions)



* Includes 2% annual cost of living adjustment.
Source: State Budget Agency; IFPI Calculations.

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obligations will begin to rapidly rise over the next two decades. According to IFPI projections, total TRF obligations, assuming a 2% annual cost of living adjustment (COLA), are projected to increase 439.5% between FY 1996 and FY 2015, from \$240.6 million to \$1,298.1 million, a 9.3% average annual increase. Given the fact that state GF revenue has increased at an average annual rate of only 5.8% since 1984, the rapid rise in the level of state support for TRF obligations would most likely force lawmakers to either reduce the level of state support for other government services, increase taxes, or both.

The Solution: The Pension Stabilization Fund

In anticipation of this looming fiscal crisis, the 1995 General Assembly created the Pension Stabilization Fund (I.C. 21-6.1-2-8), a dedicated fund which will begin receiving \$55.0 million annually in FY 1996, including \$30.0 million in reinstated lottery funds and \$25.0 million in GF appropriations. In addition, the state transferred \$425.0 million from the employer reserve of the pre-1996 plan to this fund. After accumulating balances and interest over the next ten years, the Pension Stabilization Fund will be used to maintain GF appropriations for TRF obligations as a constant percentage of state GF revenue. In other words, the Pension Stabilization Fund provides an alternative to a reduction in government services or a tax increase by maintaining a consistent and manageable relationship between the growth in state appropriations for retiree benefits and the growth in state GF revenue.

As Figure 1 illustrates, state GF appropriations alone will continue to support TRF obligations over the next decade. Then, between FY 2006 and FY 2027, the state will utilize

balances in the Pension Stabilization Fund to maintain a 5.9% annual growth in state GF appropriations for TRF obligations.

Though initial payments from this fund are projected to be relatively small (\$25.9 million in FY 2006), payments from the Pension Stabilization Fund are projected to reach \$460.7 million in FY 2019. In sum, total net payments from this fund are projected to exceed \$4.7 billion by FY 2028, the year in which balances in the Pension Stabilization Fund are projected to be exhausted.

Conclusion

While the new fully-funded TRF plan represents the first step in addressing the TRF's unfunded liability, the creation of the Pension Stabilization Fund must be viewed as the most critical step taken by the state in its attempt to adequately fund teacher retirement benefits in Indiana. However, the success (or failure) of the Pension Stabilization Fund in addressing the TRF's unfunded liability is largely dependent upon whether the General Assembly (a) maintains the \$55.0 million annual appropriation to the fund; (b) maintains the scheduled increases in state GF appropriations for TRF obligations; and (c) withstands the temptation to utilize balances in the fund to provide COLAs for teachers.

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