

A Balcony View
of the
Kentucky Pension Crisis

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Introduction

A government makes promises to the public and to its employees, but what happens if the government finds itself unable to keep those promises? A private company can go bankrupt, but as of today, states are not allowed to do that.¹ So what options does a state have when they become financially unsustainable? Government intervention in the private market is often needed when there is a market failure. What happens when the government upsets, rather than stabilizes, the economy?

These are the issues facing the Commonwealth of Kentucky right now. The state's pension system suffers from years of chronic underfunding² and they now find themselves billions of dollars shy of what will be needed in the near future. The working number for how much the state owes its pension system has been \$37 billion.³ However, a Moody's report issued on July 21, 2017 doubled that number to \$70 billion in unfunded pension liabilities⁴. To put that in context, the amount the state of Kentucky owes its worker's pension funds is more than *seven times* the Commonwealth's entire \$10 billion annual General Fund budget.⁵

Who is this money owed to? More than 8% of the Commonwealth's population: over 360,000 Kentuckians,⁶ including firefighters, police, teachers, city, state employees,

¹ John Mauldin, "Don't Be So Sure That States Can't Go Bankrupt," *Forbes*, Jul 28, 2016,

² Ben Walsh and Travis Waldron, "Kentucky's Hedge Funder Governor Keeps State Money In Secretive Hedge Funds," *HuffPost*, June 24, 2017, http://www.huffingtonpost.com/entry/matt-bevin-kentucky-pensions_us_594bf56ce4b0a3a837be3d56, (accessed July 27, 2017).

³ Tom Loftus, "Pension costs just jumped for Kentucky's school districts, local governments," *Courier-Journal*, July 12, 2017, <http://www.courier-journal.com/story/news/politics/2017/07/12/pension-costs-just-jumped-kentuckys-school-districts-local-governments/467408001/>, (accessed July 27, 2017).

⁴ Moody's Investors Service, "Kentucky (Commonwealth of) Update - Moody's downgrades Kentucky to Aa3; outlook stable," (July 20, 2017): 5.

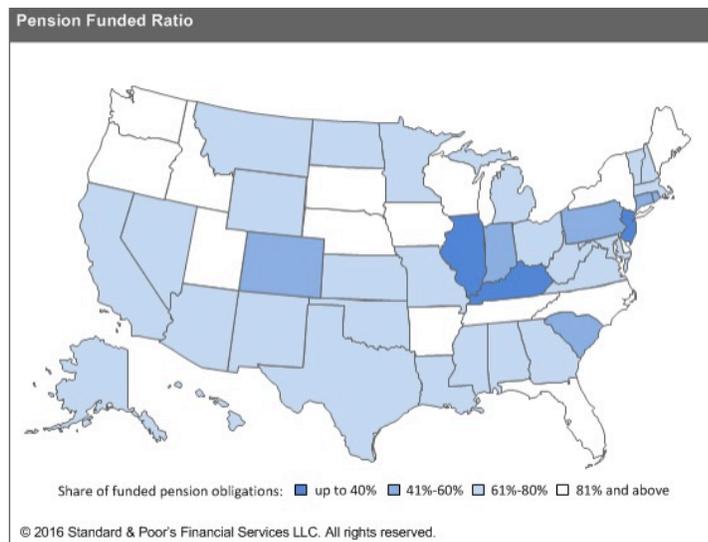
⁵ William M. Landrum III, Edgar C. Ross and Donald Sweasy, "Commonwealth of Kentucky Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2015," 141, <http://finance.ky.gov/Office%20of%20the%20Controllor/2015CAFR.pdf> (accessed July 27, 2017).

⁶ "Kentucky's Pension Crisis – Frequently Asked Questions," (March 2016): 1, <https://kypensioncrisisdotcom.files.wordpress.com/2016/03/pension-faq.pdf>, (accessed July 27, 2017).

transportation employees, social workers, mental health workers, university employees,⁷ are counting on these benefits for their future financial security.

A new study shows that Kentucky’s pension system is one of the most poorly funded in the nation and the Commonwealth is doing the worst at paying off its pension debt.⁸ Based on plan information reported through the end of fiscal 2015, the median funded ratio across state plans was 74.6%, but for Kentucky, the funded ratio was only 37.4% (based on earlier S&P numbers), as shown in Figure 1.⁹

Figure 1¹⁰



Fiscal 2015 Best-Funded Pension Ratios	
South Dakota	104.1
Wisconsin	102.7
New York State	98.1
North Carolina	94.6
Florida	92.0

Fiscal 2015 Worst-Funded Pension Ratios	
Kentucky	37.4
New Jersey	37.8
Illinois	40.2
Connecticut	49.4
Rhode Island	55.5

⁷ Tom Loftus, “Don’t cut our pensions amid crisis, public workers tell Kentucky board,” Courier-Journal, June 26, 2017, <http://www.courier-journal.com/story/news/politics/2017/06/26/stakeholders-give-their-views-pension-reforms/421347001/>, (accessed July 27, 2017).

⁸ Ryland Barton, “Kentucky’s Pensions Are Worst-Funded In U.S., Study Shows,” WFPL, September 15, 2016, <http://wfpl.org/studies-show-kentuckys-state-pensions-worst-in-nation/>, (accessed July 27, 2017).

⁹ Sussan S. Corson, “U.S. State Pensions: Weak Market Returns Will Contribute To Rise In Expense,” Standards and Poor, (September 12, 2016): 7, <http://www.nasra.org/files/Topical%20Reports/Credit%20Effects/SPGlobalstates1609.pdf>, (accessed July 27, 2017).

¹⁰ Corson, “U.S. State Pensions: Weak Market Returns Will Contribute To Rise In Expense,” 7.

Because of the magnitude of the debt and the size of the Commonwealth's budget, this trend will be difficult to change. But without drastic change, the state will continue to fall behind faster than any other state.¹¹

So how did this financial disaster come about? Was it preventable? What are the steps the Commonwealth might take to address it? As Governor Matt Bevin considers calling a special legislative session¹² to address this crisis (and a recently discovered budget deficit from 2016-2017 fiscal year)¹³ these are some questions citizens of the Commonwealth might be asking and that are addressed in the following sections of this paper. There have been many books and articles about this issue, this paper hopes to present an easily digestible overview of the various issues and potential paths out of financial collapse that the Commonwealth might take to right its course. Let's begin with a more in-depth overview of the history: How did Kentucky get into this mess?

History/Overview

There are a variety of factors that led the Commonwealth to this dire state, both internal decisions about the amount that was set-aside as well as externalities that negatively affected the money that *was* invested.

Internal Decisions

The Budget

In discussing the budget decisions that were made, it is important to understand actuarial assumptions that provide the basis for determining how much gets put into the various pension funds, as well as the process by which the Commonwealth creates the budget.

¹¹ Barton, "Kentucky's Pensions Are Worst-Funded In U.S., Study Shows."

¹² A special session would cost more than \$63,000 a day, according to the Legislative Research Commission.

¹³ Tom Loftus, "Can public pension benefits be cut? Kentucky officials looking into it," Courier-Journal, July 14, 2017, <http://www.courier-journal.com/story/news/politics/2017/07/14/can-public-pension-benefits-cut-kentucky-officials-looking-into/434944001/>, (accessed on July 27, 2017).

The annual required contribution (ARC) was adopted in the 1990s and is the “unofficial measuring stick of the effort states and local governments are making to fund their pension plans.”¹⁴ The ARC uses actuarial data about how many people are in the plan, estimates on how long people will live and require benefits from the plan, and other factors, to determine how much a state needs to set aside each year to fund its pensions. National Association of State Retirement Administrators (NASRA) declares that “Assuming projections of actuarial experience hold true, an allocation short of the full ARC means the unfunded liability will grow and require greater contributions in future years.” This is what happened with Kentucky – for 15 of the last 22 years, the Commonwealth did not allocate the full ARC amount and so their unfunded liability has grown.¹⁵

The reason behind this decision by legislatures to not fund the full ARC amount was a political one. According to Chris Tobe, a former trustee and Investment Committee member for the umbrella Kentucky Retirement System who has applied for SEC whistleblower status and wrote the book Kentucky Fried Pension in 2013 about the pension crisis, while there is an official process for the creation of the biennial budget, the unofficial budget is drafted by the Governor, the House Speaker and the Senate President behind closed doors.¹⁶ Republicans have led the Senate since 2000.¹⁷ Democrats led the House for 95 years until the 2016 election, at

¹⁴ Keith Brainard and Alex Brown, “Spotlight On: The Annual Required Contribution Experience of State Retirement Plans, FY 01 to FY 13,” National Association of State Retirement Administrators, March 2015 http://www.nasra.org/files/JointPublications/NASRA_ARC_Spotlight.pdf, (accessed on July 27, 2017).

¹⁵ Ryland Barton, “Kentucky’s Pensions Are Worst-Funded In U.S., Study Shows.”

¹⁶ Chris Tobe, phone conversation with author, Louisville, KY, July 24, 2017.

¹⁷ "President of the Kentucky Senate," in *Wikipedia: The Free Encyclopedia*; (Wikimedia Foundation Inc., 23 January 2016, at 14:53), https://en.wikipedia.org/wiki/President_of_the_Kentucky_Senate (accessed July 27, 2017).

which point Republicans took control.¹⁸ Since 2000, the Governorship has alternated between Republican and Democratic leaders.

Because of this configuration, these behind-closed-doors negotiations on the budget have been compromises along political lines. According to Tobe, Republicans have insisted that they cannot raise taxes. Democrats have insisted that programs could not be cut. Because Kentucky requires a balanced budget,¹⁹ the money had to come from somewhere and so legislators “raided” the pension fund by not fully funding the ARC. This bi-partisan practice dates back to 2002.²⁰

Not fully funding the ARC created an unfunded liability that has grown over the years. Additionally, while cost of living adjustments (COLAs) have been promised to some union members and state employees upon retirement (i.e., teachers) these increases have not been funded in the biennial budgets.²¹

Non-Government Participation

When the Commonwealth’s pension plan was set up in the 1950’s, it extended benefits to organizations far beyond government agencies. While it is not uncommon for non-government organizations to participate in a state’s pension plan, the situation in Kentucky has taken that to the extreme. Tobe reports that nearly a third of the organizations participating in the state’s pension plan are non-government. These organizations include medical providers, not-for-profit law firms, social service agencies, advocacy organizations, entertainment venues, a laundry that

¹⁸ Jack Brammer and Linda Blackford, “Republicans take the Kentucky House after 95 years of Democratic control,” *Lexington Herald Leader*, November 8, 2016, <http://www.kentucky.com/news/politics-government/article113464563.html> (accessed July 27, 2017).

¹⁹ “Legislative Role in the State Budget Process,” Kentucky State Legislature, <http://www.lrc.ky.gov/budget/process.htm> (accessed July 27, 2017).

²⁰ Boyd, “Chris Tobe: Pension crisis means next Ky. governor will raise taxes, cut education like never before.”

²¹ Kentucky Chamber of Commerce, “A Citizens Guide to Kentucky’s Pension Crisis,” 2, <https://www.kychamber.com/sites/default/files/Pension%20Crisis%20-%20Feb%2025%20Edits.pdf> (accessed July 27, 2017).

washes hospital linens, and the state’s largest credit union. Tobe suggests that there are approaching 3000 non-government organizations participating.²²

While at first glance, this may seem to make sense – it can be beneficial to expand the number of organizations supporting the program –the potential problem with this arrangement became clear with the case of Seven Counties Service, a Louisville non-profit that provides mental health support that was participating in the plan. Seven Counties argued that their pension contributions “consumed more than two-thirds of the group's gross revenue”²³ and declared bankruptcy. The chief executive argued that the \$227 million that it was responsible for funding was an amount that they wouldn’t be able to pay off in “200 years.”²⁴ A judge declared that, as a private entity, the organization could, indeed, leave Kentucky’s pension system.

Insider Louisville reports “Kentucky and many of its institutions such as Jefferson County Public Schools are functionally bankrupt because of their exposure to Kentucky’s public-employee pension crisis.”²⁵ They owe so much to the pension system – often more than the funding they receive from the state – that as more and more of them withdraw in order to leave behind their unfunded pension liabilities, it will reduce the number of organizations contributing to the already-struggling pension plan and will result in driving up costs for public employers who do not have the ability to withdraw.²⁶

²² Tobe, “Kentucky Fried Pensions,” 145.

²³ Mike Wynn, “Seven Counties can leave indebted Ky. pension system,” Courier-Journal, May 13, 2014, <http://www.courier-journal.com/story/news/politics/ky-legislature/2014/05/31/seven-counties-can-leave-indebted-ky-pension-system/9806107/> (accessed July 27, 2017).

²⁴ Tobe, “Kentucky Fried Pensions,” 148.

²⁵ Staff, “Judge rules Seven Counties can take bankruptcy,” Insider Louisville, <https://insiderlouisville.com/metro/judge-issues-order-seven-counties-services-bankruptcy-proceedings/>, (May 31, 2014).

²⁶ Wynn, “Seven Counties can leave indebted Ky. pension system.”

Oversight Issues

One might wonder where the watchdogs were in this scenario. Unfortunately, the Kentucky watchdogs were either absent, ignored or let go from their positions when they started barking. According to the website of the State Auditor, there have been no reports on the pension crisis outside of a 2015 audit report²⁷ on one fund which was focused on the schedule of employer allocations. No red flags were issued in this report. Tobe shared in an interview that the last comprehensive report he is aware of is the one that he wrote for the State Auditors office over 19 years ago, in 1998.

Gov. Steve Beshear (D) fired Tobe in 2012, the only professional investment expert on the investment committee, for raising the alarm.²⁸ In 2017, Governor Bevin (R) fired Thomas Elliott, who was chair of one of the pension boards and a former banker. Bevin's spokesperson said that this firing was meant to give Kentucky "a fresh start and more transparency,"²⁹ but a dermatologist replaced Elliot, a former banker. However, as the Huffington Post reports,

Elliott didn't go quietly — he chaired the board's April [2017] meeting despite Bevin's order removing him. The governor picked a dermatologist to replace Elliott, but that individual never assumed the seat, withdrawing in May after the state attorney general said he lacked the requisite investment experience and that Elliott's firing had been improper. Bevin showed up at the board's May meeting with state troopers to physically bar Elliott from acting as chair.³⁰

²⁷ Adam Edelen, "Report Of The Audit Of The Schedule Of Employer Allocations And Schedule Of Pension Amounts By Employer For The Kentucky Teachers' Retirement System As Of and For The Fiscal Year Ended June 30, 2014," KY Auditor of Public Accounts website, http://apps.auditor.ky.gov/Public/Audit_Reports/Archive/2014ktrsproportionateshareaudit.pdf (accessed July 27, 2017).

²⁸ Terry Boyd, "Chris Tobe: Pension crisis means next Ky. governor will raise taxes, cut education like never before," Insider Louisville, June 16, 2014, <https://insiderlouisville.com/metro/chris-tobe-pension-crisis-means-next-ky-governor-will-raise-taxes-cut-education-like-never/> (accessed July 27, 2017).

²⁹ Walsh and Waldron, "Kentucky's Hedge Funder Governor Keeps State Money In Secretive Hedge Funds."

³⁰ Walsh and Waldron, "Kentucky's Hedge Funder Governor Keeps State Money In Secretive Hedge Funds."

Nationally, private employers are held accountable to ERISA, the Employee Retirement Income Security Act of 1974, which “protects the assets of millions of Americans so that funds placed in retirement plans during their working lives will be there when they retire.”³¹ However, there is no such oversight for state employees. Organizations such as NASRA, the Employee Benefits Research Institute, the National Conference on Public Employee Retirement Systems, and the State and Local Pension Exchange provide guidelines for states but they do not provide regulatory oversight. Additionally, while some states have adopted ERISA-like requirements or other pension reform for their pension programs, as of July 2017, Kentucky has not. Senate Bill 2 has been submitted for several years, with a goal of increasing transparency in the pension program, but two major reform provisions (measures to require full fee disclosure and competitive bidding) were noticeably removed from previous versions.³²

Negative Externalities

A negative externality is “a cost that is suffered by a third party as a result of an economic transaction. In a transaction, the producer and consumer are the first and second parties, and third parties include any individual, organisation, property owner, or resource that is indirectly affected.”³³ There are two negative externalities that have impacted the Kentucky pension system: the market failure of 2008, and the fees that the Commonwealth pays to hedge fund managers. In both these instances, the producer is the financial market, the consumer is the Commonwealth, and the third party impacted is the pension system.

³¹ “Retirement Plans and ERISA FAQs,” Department of Labor, <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/faqs/retirement-plans-and-erisa-consumer> (accessed July 27, 2017).

³² Walsh and Waldron, “Kentucky’s Hedge Funder Governor Keeps State Money In Secretive Hedge Funds.”

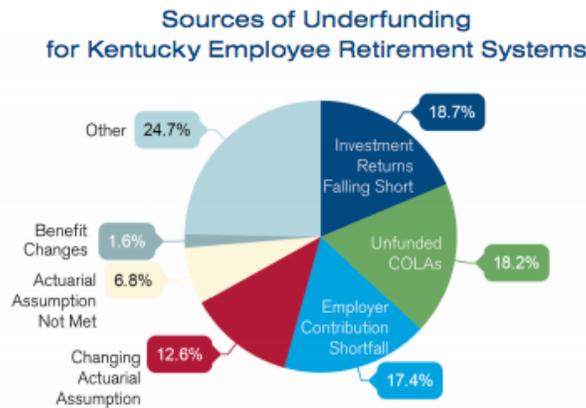
³³ “Negative Externalities,” Economics Online, http://www.economicsonline.co.uk/Market_failures/Externalities.html (accessed July 27, 2017).

Market collapse

According to NASRA, after the 2008 market collapse, most U.S. state pension plans suffered serious losses and “have not been able to recover to funded levels seen in the early 2000s.”³⁴ Kentucky is not alone in this.

The Kentucky Chamber of Commerce has issued “A Citizens Guide to Kentucky’s Pension Crisis”,³⁵ in which they affirm the role of the market collapse in the Commonwealth’s struggling pension system. In Figure 2, from that report³⁶, one can see that while budgetary issues account for 35.6% of the underfunding (17.4% for the state’s failure to contribute to the pension funds via budget allocations and 18.2% for unfunded COLAs), another 18.7% can be attributed to investments falling short of the predicted amount. The impacts of the market collapse will be examined in more detail below in the section on *Estimate Failure* below.

Figure 2³⁷



³⁴ Corson, “U.S. State Pensions: Weak Market Returns Will Contribute To Rise In Expense,” 2.

³⁵ Kentucky Chamber of Commerce, “A Citizens Guide to Kentucky’s Pension Crisis.”

³⁶ However, this report is not without it’s detractors. It was funded by a former Enron Billionaire and is considered a false political one by many. According to Tobe, more reliable reports attribute 70% or more of the crisis to underfunding.

³⁷ Kentucky Chamber of Commerce, “A Citizens Guide to Kentucky’s Pension Crisis,” 6.

High Fees

Another factor in the struggling Kentucky pension system is the reliance on “alternate investments.” These alternate investments include vehicles such as hedge funds, which “carry far more risk than traditional investments in stocks and bonds — and much higher fees.”³⁸ In 2015 alone, the state paid more than \$100 million in investment fees related to its pensions.³⁹

This issue will be examined further under *Ethical Failure*. For this section, it will suffice to say that Kentucky has been paying exorbitant fees for “risky financial products that rarely outperform the market.”⁴⁰

Current Status

The factors mentioned above, plus a confluence of changes in the actuarial tables have contributed to make Kentucky’s pension system one of the most disastrous in the country. In his book, Kentucky Fried Pensions, Tobe states “Pensions have historically been considered unhealthy if they are under an 80% funding level, and at 60% may be unrecoverable.”⁴¹ The Moody’s report, shown in Figure 3 indicates that two specific funds within the Kentucky pension system make up the vast majority of the Commonwealth’s liability: KTRS is funded at 32% and has 9.2 years of benefit payments covered by current assets; and KERS is funded at 11% and only has 2.1 years of benefit payments covered by current assets.⁴²

In his letter to lawmakers June 6, Gov. Bevin noted that a consultant recently found (using the S&P deficit of \$37 billion) that pension plans will need an additional \$700 million a

³⁸ Walsh and Waldron, “Kentucky’s Hedge Funder Governor Keeps State Money In Secretive Hedge Funds.”

³⁹ Walsh and Waldron, “Kentucky’s Hedge Funder Governor Keeps State Money In Secretive Hedge Funds.”

⁴⁰ Walsh and Waldron, “Kentucky’s Hedge Funder Governor Keeps State Money In Secretive Hedge Funds.”

⁴¹ Chris Tobe, “Kentucky Fried Pensions,” CreateSpace Independent Publishing Platform, (July 16, 2013): 9.

⁴² Moody’s Investors Service, “Kentucky (Commonwealth of) Update - Moody's downgrades Kentucky to Aa3; outlook stable,” 5.

year.⁴³ This is nearly 7% of the annual General Fund revenue.⁴⁴ Eliminating the earlier \$37 billion deficit would require \$7,349 dollars from the piggy banks of every single one of the 4.3 million men, women and children in Kentucky.⁴⁵ Presumably, that number will be substantially higher using Moody’s new, revised estimate of a \$70 billion deficit in the pension fund.

Figure 3⁴⁶

Two plans account for roughly 95% of Kentucky's pension exposure

\$000s	KERS - Non Haz	TRS
Measurement Date	2016	2016
State Financial Reporting Year	2017	2017
Total Pension Liability	\$13,379,782	\$47,736,901
Plan Fiduciary Net Position	\$1,980,292	\$16,812,832
Net Pension Liability	\$11,399,490	\$30,924,069
GASB Funded Ratio	15%	35%
GASB Discount Rate	6.75%	4.20%
Citi Pension Liability Index	3.61%	3.61%
Moody's Adj. Liability	\$18,463,974	\$51,898,466
ANPL	\$16,483,682	\$35,085,634
Adj. Funded Ratio	11%	32%
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Tread Water	\$790,346	\$1,245,707
Employer Contributions	\$513,084	\$565,455
Employee Contributions	\$106,494	\$313,044
Benefits and Expenses	(\$946,406)	(\$1,833,199)
Est. Years of Benefit Pmts Covered by Current Assets	2.1	9.2
State Allocation (as of FY 2016)	70%	95%

Source: commonwealth financial reports and Moody's Investors Service

A Series of Failures

The history outlined above gives an overview of how Kentucky arrived at this pension crisis. Digging in and doing an analysis of these factors, there are three key areas of failure:

⁴³ Tom Loftus, “Gov. Matt Bevin faces tough sell on tax reform, even among Republican allies,” Courier-Journal, June 23, 2017, <http://www.courier-journal.com/story/news/politics/2017/06/23/gov-matt-bevin-faces-tough-sell-tax-reform-even-among-republican-allies/415491001/> (accessed July 27, 2017).

⁴⁴ Loftus, “Gov. Matt Bevin faces tough sell on tax reform, even among Republican allies.”

⁴⁵ Jim Waters, “Bluegrass Beacon — Change the culture of secrecy: Pledge transparency,” Bluegrass Institute, October 30, 2016 <http://www.bipps.org/bluegrass-beacon-change-culture-secrecy-pledge-transparency/> (accessed July 27, 2017).

⁴⁶ Moody’s Investors Service, “Kentucky (Commonwealth of) Update - Moody's downgrades Kentucky to Aa3; outlook stable,” 5.

budgeting, estimating, and ethics. These failures have conspired to damage credit ratings for Kentucky, which will have continuing impacts on the financial status of the Commonwealth.

Budget Failure

Earlier this month, the Office of State Budget Director announced that revenue to the state's General Fund was \$138.5 million short of what had been projected in the 2016-2017 fiscal year. The Courier-Journal reports "The largest factor in the budget shortfall was corporate income tax revenue, as this amount fell by 5.5 percent from the previous fiscal year and was \$81.9 million less than what was projected. The state budget office stated that this is the second consecutive fiscal year in which corporate income tax revenue has declined, following 'five years of extremely strong growth.'"⁴⁷

A budget shortfall of this amount would normally not be too worrisome as it is just of 1% of the revenues. However, this shortfall comes after legislators had already approved spending cuts "of 4.5 percent for most state agencies in the most recently enacted budget."⁴⁸ Additionally, legislators have finally begun contributing more revenues to the struggling pension system.⁴⁹

Kentucky's debt service to its pension system is becoming a larger and larger proportion of the budget. As shown in Figure 4 below, in the last 10 years, the Commonwealth's pension spending has increased nearly five times as fast as revenues. Along with fast growing Medicaid

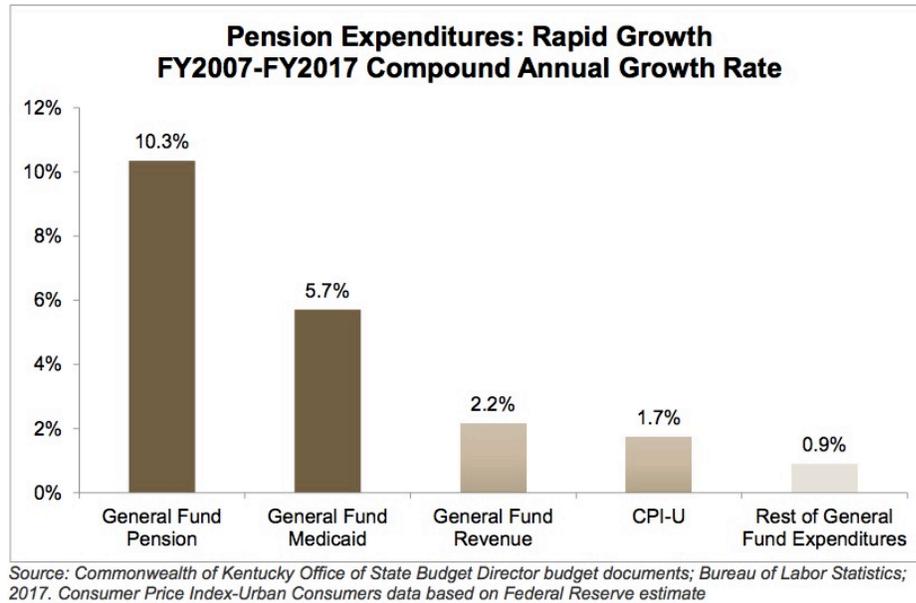
⁴⁷ Joe Sonka, "Kentucky's General Fund had \$138M shortfall in 2016-2017 fiscal year, ahead of possible special legislative session on tax reform," Insider Louisville, July 11, 2017, <https://insiderlouisville.com/metro/kentuckys-general-fund-has-138-million-shortfall-in-2016-2017-fiscal-year-ahead-of-possible-special-legislative-session-on-tax-reform/> (accessed July 27, 2017).

⁴⁸ Adam Beam, "Kentucky's Retirement Debt Soars After Pessimistic Outlook," US News, May 18, 2017, <https://www.usnews.com/news/best-states/kentucky/articles/2017-05-18/kentuckys-retirement-debt-soars-after-pessimistic-outlook> (accessed July 27, 2017).

⁴⁹ John Cheves, "Kentucky's public pension debt just got billions bigger," Lexington Herald Leader, May 18, 2017, <http://www.kentucky.com/news/politics-government/article151237297.html> (accessed July 27, 2017).

costs, this has severely constrained growth in the rest of the budget, even as the Commonwealth’s population has increased.⁵⁰

Figure 4⁵¹



The question arises: is this sustainable? The answer, unfortunately, is no. Kentucky is not a wealthy state. It is ranked in 46th-place (out of 50) in income and 18 percent of its population lives below the poverty level.⁵² The long-term debt that the Commonwealth owes far outpaces its assets – computed from the 2015 CAFR, it’s debt ratio is 1.4, meaning it owes nearly one and a half times what the Commonwealth’s assets are.⁵³ Drastic measures will be required to correct this situation.

⁵⁰ PRM Consulting Group Stites & Harbison PLLC, “Commonwealth of Kentucky Pension Performance and Best Practices Analysis, Interim Report #2: Historical and Current Assessment,” (May 22, 2017): 26, <http://osbd.ky.gov/Documents/Pension%20Reform/2017%2005%2022%20-%20Report%20%20FINAL%205.22.17%20combined.pdf> (accessed July 27, 2017).

⁵¹ PRM Consulting Group, “Commonwealth of Kentucky Pension Performance and Best Practices Analysis,” 27.

⁵² Kentucky Chamber of Commerce, “A Citizens Guide to Kentucky’s Pension Crisis,” 5.

⁵³ Long Term Debt Ratio = Long-term liabilities / Total Assets, 39,567,582 / 28,962,189 = 1.36 from Landrum III, Ross and Sweasy, “Commonwealth of Kentucky Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2015,” 27.

Estimate Failure

Assumptions matter, especially when it comes to pension plans worth billions of dollars. If one is trying to accumulate a specified amount and assumes an 8% rate of return on investments, then they will need to contribute substantially less to a plan to reach that specified amount than they would need to if they assumed only a 4% return. Many states, including Kentucky, have overestimated returns and thus not contributed enough to their pension plans. As the S&P report points out:

When public pension plans assume a lower rate of return, all else being equal, governments must dedicate a greater proportion of their revenue to pension contributions to meet the higher estimated pension liability. Continued trends of slow revenue growth, growing liabilities, and higher future pension contribution costs could amplify an already constrained budget environment for many states.⁵⁴

The assumptions that were made prior to the market collapse in 2008-2009 did not hold true after the collapse, and yet many states, including Kentucky, failed to adjust to assume a lower rate of return, even though these returns are no longer predicted.⁵⁵

This failure in estimation artificially inflated the amount that Kentucky had in its pension accounts. Earlier this month, when the pension board voted to lower the assumed return to 6.25 percent from 7.5 percent⁵⁶, in essence this grew the state's pension debt by over \$2 billion. As a result, the state will have to find a way to pay significantly more into the system to keep it solvent.⁵⁷

⁵⁴ Corson, "U.S. State Pensions: Weak Market Returns Will Contribute To Rise In Expense," 2.

⁵⁵ Corson, "U.S. State Pensions: Weak Market Returns Will Contribute To Rise In Expense," 3.

⁵⁶ Loftus, "Pension costs just jumped for Kentucky's school districts, local governments."

⁵⁷ Beam, "Kentucky's Retirement Debt Soars After Pessimistic Outlook."

Ethics Failure

Pensions are a fiduciary fund, meaning that these funds “cannot be used to support the government’s own programs and operations.”⁵⁸ And yet that is exactly what Kentucky did for over a decade. Without the federal oversight that a private organization would receive, the state was able to continue this behavior since elected officials across the aisle were on board.

A team of investigators, looking into Kentucky’s pension crisis, found that there are two main contributing factors: “the practice of awarding benefits retroactively and a failure by legislators to obtain a cost analysis prior to enhancing benefits.”⁵⁹ It should be noted that both of these practices “reflect repeated violations of the Kentucky Constitution and state statute.”⁶⁰

In Kentucky Fried Pensions, Tobe connects the dots between unethical corruption in pension investing to unethical corruption in underfunding pension accounts. He asserts, “pension cultures that are willing look the other way regarding unsavory investment dealings will go along with bogus pension funding schemes as well.”⁶¹

There are other ethical issues that are alive and needing to be addressed. Questions are being asked about the pension system’s reliance on hedge funds and private equity. HuffPost reports that a year prior to Gov. Bevin’s election “the pension system had 25 percent more alternative investments than its peers, 27 percent higher costs and 15 percent lower long-term returns, according to a report prepared for the pension board.” As a part-owner of a hedge fund himself, Bevin said in 2015 that he didn’t have a problem with the pension system’s heavy

⁵⁸ XiaoHu Wang, *Financial Management in the Public Sector* (New York: ME Sharpe, 2014), 141.

⁵⁹ Jim Waters, “News Release: Confronting pension crisis calls for reforming benefits structure,” Bluegrass Institute, March 27, 2017, <http://www.bipps.org/newsrelease-confronting-pension-crisis-calls-reforming-benefits-structure/> (accessed July 27, 2017).

⁶⁰ Waters, “News Release: Confronting pension crisis calls for reforming benefits structure.”

⁶¹ Edward Siedle, “Kentucky Fried Pensions,” *Forbes*, August 8, 2013, <https://www.forbes.com/sites/edwardsiedle/2013/08/08/kentucky-fried-pensions/#3e47daf54470> (accessed July 27, 2017).

reliance on alternative investments like hedge funds,⁶² even though they have higher fees and lower rates of return!

Indeed, besides the Governor, Bevin has appointed two hedge fund managers to the pension board.⁶³ This raises concerns that general assembly members, people on the pension system's board and even the governor himself might make decisions to benefit themselves rather than the pension programs.⁶⁴

These ethical failures point out the need for more transparency and oversight over the Commonwealth's investing decisions.

Damaged Credit

Failures in budgeting, estimation and ethics have contributed to a situation where Kentucky owes substantial amounts to its pension system. This, in turn, has caused credit agencies (both S&P and Moody's)⁶⁵ to downgrade the Commonwealth's credit rating because, "a state's prudent management of its long-term liabilities is important for long-term credit stability"⁶⁶ and Kentucky has shown no such prudent management.

S&P shared the view that "there exists at least a one in three chance that funding levels of the Commonwealth's pension plans could significantly weaken and associated fixed costs could continue to grow to a level that...will continue to be a significant drag on the Commonwealth's rating."⁶⁷

In addition to having to cut essential programs from the budget in order to allocate more money to the pension system, the downgrade means it will cost more to build roads, schools and

⁶² Walsh and Waldron, "Kentucky's Hedge Funder Governor Keeps State Money In Secretive Hedge Funds."

⁶³ Walsh and Waldron, "Kentucky's Hedge Funder Governor Keeps State Money In Secretive Hedge Funds."

⁶⁴ Walsh and Waldron, "Kentucky's Hedge Funder Governor Keeps State Money In Secretive Hedge Funds."

⁶⁵ Kentucky Chamber of Commerce, "A Citizens Guide to Kentucky's Pension Crisis," 1.

⁶⁶ Corson, "U.S. State Pensions: Weak Market Returns Will Contribute To Rise In Expense," 2.

⁶⁷ PRM Consulting Group, "Commonwealth of Kentucky Pension Performance and Best Practices Analysis," 32.

other important projects that serve the public.⁶⁸ The Kentucky Chamber of Commerce looks to Illinois as an example of what will happen in Kentucky:

A downgrade of Illinois' credit rating due to pension liabilities even higher than Kentucky's increased the cost of a \$1.3 billion bond issue for construction projects in that state by \$95 million over the term of the bonds. This increased cost was enough to fund the construction of at least four high schools or 12 elementary schools.⁶⁹

The increased costs for new and existing projects will mean even *more* of the Commonwealth's revenue will be tied up in debt repayment and could be devastating to a state that already struggles – it is 47th out of 50 states in terms of educational attainment⁷⁰, 44th in healthcare, 46th in infrastructure,⁷¹ 46th for income and 18 percent of its population live below the poverty level.⁷²

Potential Solutions

Common sense indicates that when there is a budget crisis, one has two choices: raise revenue or cut expenses. In the case of Kentucky's pension crisis, both of these tactics will be required, and both will be difficult. And they may not be enough.

⁶⁸ Chris Tobe, phone conversation with author, Louisville, KY, July 24, 2017.

⁶⁹ Kentucky Chamber of Commerce, "A Citizens Guide to Kentucky's Pension Crisis," 9.

⁷⁰ Simona Balazsm, "Education: Where does Kentucky rank & why does it matter?" Community & Economic Development Initiative of Kentucky, September 8, 2015, <https://cedikentucky.wordpress.com/2015/09/08/education-where-does-kentucky-rank-why-does-it-matter/> (accessed July 27, 2017).

⁷¹ "Best States: Kentucky," US News, <https://www.usnews.com/news/best-states/kentucky> (accessed July 27, 2017).

⁷² Kentucky Chamber of Commerce, "A Citizens Guide to Kentucky's Pension Crisis," 5.

Raise Revenue

The Kentucky legislature has not raised taxes in over a generation, so this might seem like a logical place to start. The last major tax increase was in 1990, when the Kentucky Supreme Court ruled that the state public school system was unconstitutional.⁷³

However, the Bluegrass Institute reported that in 2011, Kentucky had the 13th highest tax burden “as a percentage of personal income of any state government in the country.”⁷⁴ Tax burden is not the same as tax rate, which varies based on a person’s financial circumstances. The tax burden measures the exact proportion of total personal income that residents pay toward state and local taxes (including property tax, sales and excise taxes).⁷⁵ With the 13th highest tax burden already, the phrase “you can’t get blood from a stone” comes to mind.

One way to create more revenue would be to employ more people. In June 2017, Kentucky’s unemployment rate was 5.1%⁷⁶ as compared to the national rate of 4.4%⁷⁷. More telling, however, is the employment-to-population ratio, which indicates “the ratio of the labor force currently employed to the total working-age population of a region, municipality or country. It is calculated by dividing the number of people employed by the total number of people of working age.”⁷⁸ In 2015, the Bureau of Labor Statistics⁷⁹ indicated that Kentucky has

⁷³ Loftus, “Gov. Matt Bevin faces tough sell on tax reform, even among Republican allies.”

⁷⁴ BIPPS, “Note to self: ‘Kentucky cannot tax, borrow and spend its way to the Promised Land’,” Bluegrass Institute, <http://www.bipps.org/note-to-self-kentucky-cannot-tax-borrow-and-spend-its-way-to-the-promised-land/> (accessed July 27, 2017).

⁷⁵ Richie Bernardo, “2017 Tax Burden by State,” WalletHub, April 5, 2017, <https://wallethub.com/edu/states-with-highest-lowest-tax-burden/20494/> (accessed July 27, 2017).

⁷⁶ “Economy at a Glance: Kentucky,” Bureau of Labor Statistics, <https://www.bls.gov/eag/eag.ky.htm> (accessed July 27, 2017).

⁷⁷ “Economy at a Glance: United States,” Bureau of Labor Statistics, <https://www.bls.gov/eag/eag.us.htm> (accessed July 27, 2017).

⁷⁸ “Employment-To-Population Ratio,” Investopedia, http://www.investopedia.com/terms/e/employment_to_population_ratio.asp#ixzz4nlZPkIyx (accessed July 27, 2017).

⁷⁹ “State employment–population ratios in 2014,” Bureau of Labor Statistics, March 9, 2015, <https://www.bls.gov/opub/ted/2015/state-employment-population-ratios-in-2014.htm> (accessed July 27, 2017).

an employment to population ration of 54.8%. This gave Kentucky the 45th lowest ratio in the country.

If the Commonwealth could employ more of its population, it would likely be able to raise the tax base. Unfortunately, job creation usually takes an investment of revenue itself, and it can be years before the returns are seen. Due to these factors, raising Kentucky's revenue through taxes will not be sufficient to address the pension crisis.

Cut Expenses

There are two places that Kentucky might be able to cut expenses to address the pension crisis: in the pension system itself, or in the general budget.

Reduce Pension Expenses

The first, and most obvious way to cut expenses of the pension system is to move away from hedge funds. Though the fees paid to hedge fund managers are a small drop in the bucket compared to the depth of this crisis, this has the added benefit of reducing the appearance of impropriety among the state's public servants.

The second way to reduce pension expenses is to cut benefits in some way. There is much that cannot be cut, however, because pension benefits constitute what is understood as an "inviolable contract." This is a guarantee to retirees that they receive the benefits they earned under the plan they signed up for when they were hired.⁸⁰ This protects workers, some of who cannot receive Social Security benefits (such as teachers).

Regardless, some organizations, like the Bluegrass Institute, are trying to cut even these inviolable contract benefits.⁸¹ This is not going over well with retirees, however. Jim Carroll, president of the advocacy group Kentucky Government Retirees, said: "We will not accept cuts to benefits promised under an inviolable contract enunciated in state law. If a bill is considered

⁸⁰ Tom Loftus, "Can public pension benefits be cut? Kentucky officials looking into it."

⁸¹ *ibid*

that reduces promised benefits, we will storm the Capitol with torches and pitchforks. If it is signed into law, we will litigate."⁸² Governor Bevin is on the side of retirees. In a June 6 letter, he wrote, "We have a moral and legal obligation to fulfill our pension promises to current employees and retirees."⁸³

However, there are other aspects of the pension system that might be able to be cut, such as the promised, but not contractually obligated, COLAs to non-teacher beneficiaries. The Frequently Asked Questions section of "Kentucky's Pension Crisis" indicates that this is already underway:

A number of changes have been made to Kentucky pension benefits over the last 10 years. These include limits on health insurance benefits for retirees and requirements that teachers contribute more for retirement and health insurance benefits. The most significant changes were made in 2013 for state and local government employees (but not teachers). The changes placed new employees in a modified 401K-style plan with a guaranteed 4% rate of return; suspended cost of living adjustments for current retirees, and excluded employees hired after January 1, 2014 from the inviolable contract⁸⁴

In order to cut pension expenses beyond the fees incurred by hedge fund management, the question that will need further clarification is "what benefits constitute the inviolable contract?"

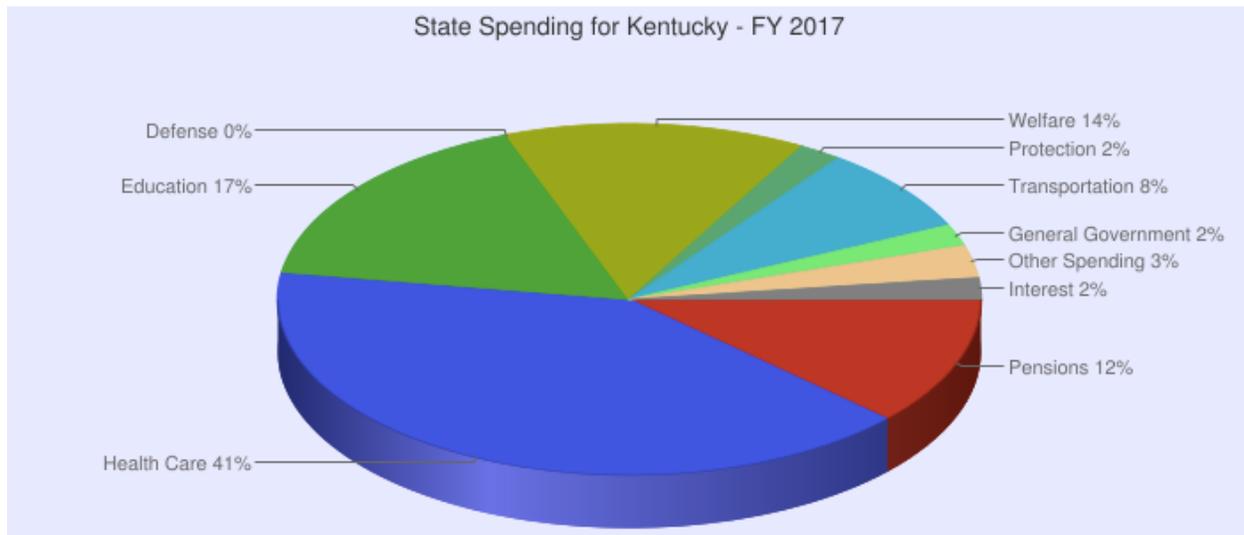
Reduce Other Budgetary Expenses

Another location to look for spending cuts would be the general budget. However, Kentucky's budget is already quite slim. As figure 5 demonstrates, healthcare and pensions make up over half the budget. Since these areas are not easily adjusted (if at all), the next largest target would be education.

⁸² *ibid*

⁸³ *ibid*

⁸⁴ "Kentucky's Pension Crisis – Frequently Asked Questions," 3.

Figure 5⁸⁵

Unfortunately, Kentucky has already cut education extensively. Insider Louisville reports that while most states are starting come back from the recession and to increase their higher education budgets, “Kentucky is one of 11 states that continued to cut this year, and is one of only three states to do so in each of the past two years. The two-year budget recently passed by the Kentucky General Assembly will further extend a 4.5 percent cut to higher education going forward.”⁸⁶

In addition, many state-funded universities are finding that their pension liabilities are growing faster, or even surpassing the funding they receive from the state. Universities such as Eastern Kentucky University and Western Kentucky University are already privatizing aspects of their organization (such as janitorial services) and may seek further ways to withdraw from the

⁸⁵ “Kentucky’s Biggest State Government Programs,” US Government Debt, http://www.usgovernmentdebt.us/year_spending_2017KYbs_18bs2n#usgs302 (accessed July 27, 2017).

⁸⁶ Joe Sonka. “Kentucky’s higher education budget cuts remain among highest in the country,” Insider Louisville, May 19, 2016, <https://insiderlouisville.com/metro/education-community/kentucky-higher-ed-budget-cuts-among-highest/> (accessed July 27, 2017).

state pension system all together. This will have a similar impact on the pension system as when Seven Counties withdrew (detailed above).⁸⁷

Cutting education would be devastating to Kentucky's already struggling education system, and could backfire as public universities declare bankruptcy, privatize, and withdraw from the pension system.

A third option?

Though states have not traditionally been able to declare bankruptcy that might be changing. Illinois, whose pension system is the only one in more dire straights than Kentucky's, is looking at potentially declaring bankruptcy – the first state to do so.⁸⁸ This would need to be approved by Congress, and may look similar to the legislation Congress passed allowing Puerto Rico to declare bankruptcy just a few months ago.⁸⁹

While there are many aspects of declaring bankruptcy that would be concerning, it is one option that should not be dismissed as Kentucky considers how to address this crisis.

Conclusion

Kentucky's pension crisis was long in the making and will not be resolved quickly or easily. There are many difficult decisions ahead for the Commonwealth. Decades of governors and legislators who have failed the test of the public good by kicking the can down the road to future generations are finding they must make amends, but the vehicles with which to so do are limited. Additionally, residents of the state are unlikely to have confidence or support solutions until and unless the ethical corruption issues are addressed through legislation that increases transparency at all levels of this issue.

⁸⁷ Chris Tobe, phone conversation with author, Louisville, KY, July 24, 2017.

⁸⁸ Aimee Picchi, "Could Illinois be the first state to file for bankruptcy?," CBS News, June 16, 2017, <http://www.cbsnews.com/news/could-illinois-be-the-first-state-to-file-for-bankruptcy/> (accessed July 27, 2017).

⁸⁹ Chris Tobe, phone conversation with author, Louisville, KY, July 24, 2017.