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RE: Written Testimony of Eric Davis on FY 2022 State Budget

Dear Legislators,

My name is Eric Davis and I'm a state employee with the Department of Environmental Conservation. I'm also the Vice-chair of the Vermont State Employees Retirement System (VSERS) Board of Trustees. I am submitting this testimony to endorse a specific budget recommendation, provide background information on the fiscal position of VSERS, and my personal perspective on finding a path forward to ensuring the State's pension liabilities are managed responsibly. I hope this testimony will be helpful as you navigate the path ahead to finalizing the FY 2022 budget. Thank you for all of the critical work you do to ensure the budget meets the needs of all Vermonters.

<u>Budget Recommendation</u>

I could not recommend in stronger terms that the legislature fully fund the Actuarial Defined Employer Contribution (ADEC) to the Vermont State Employees Retirement System of $119,967,770 as recommended by the VSERS Board of Trustees and included in the Governor's Recommended FY 2022 State Budget.

<u>Brief Background on the Recent Increase in Liabilities of VSERS</u>

There is a perspective that the pension system is in crisis and drastic actions need to be taken immediately to avert disaster. I don't believe this is true, nor a characterization that is helpful to the conversation. Please let me explain. While it is true that the funding ratio (assets/liabilities) has continued to tick downward in recent years, the two forces driving this are likely to be mitigated going forward. These two forces are: (1) the graduated schedule of state contributions and (2) adverse actuarial experience. It is important to note that the effect attributable to the first force was expected due to payments toward the unfunded liability being structured to graduate over time. Initially, payments were not adequate to cover the full cost of carrying the liability, but the state is at the turning point where the payments should begin to make steady progress on paying down the unfunded liability. In real world terms, it is somewhat analogous to reaching the point in a mortgage where you are paying more towards principal than interest.

The second force was not planned and was due to adverse actuarial experience upon annual valuations of the system. This adverse experience was largely attributable to deviations from expectations on mortality and investment returns. As an outcome of a recent experience review, a process undertaken every five years to true up the actuarial assumptions relied upon to assess the condition of the system, the Board made significant adjustments to those assumptions to ensure that trajectory of the system was headed in the right direction. If the board did not take action, it is likely additional adverse experience would have occurred at each future valuation. The action of the Board essentially recognized these costs now to reduce pressure on the system in future years. This was a difficult, but prudent and responsible decision of the fiduciaries of the system, not the sign of a crisis. That being said, it did increase the costs of the plan.

<u>A Principle to Consider: Fairness and Equity Recognize a Shared Responsibility</u>

It is my opinion, and one shared fairly widely with colleagues that I have spoken with, that state employees want to step up and be part of the solution, but also want any solution to be fair and equitable. Put simply, there should be a shared responsibility between employer and employee. It is my opinion that the recommendations included in the Treasurer's report to reduce pension liabilities do not strike an appropriate balance in this regard. Specifically, the recommendations to reduce the liabilities of the VSERS system fall almost entirely upon employees. The recent increase in liabilities was not the fault of employees, nor the State, but rather an artifact of demographics and financial market conditions. In a similar sense, VSERS benefits both employees by providing some certainty in retirement security, but also the State as a tool to attract and retain employees, as well as the broader economy by decreasing the reliance of beneficiaries on public assistance and stimulating economic activity. A fair and equitable solution is one that recognizes this shared responsibility.

<u>Comments on Avenues to Decrease Liabilities and Costs:</u>

Below, I provide my perspective on three avenues to address the increase in liabilities in the order of decreasing adverse impacts upon employees and the State.

1. *Direct payment on the unfunded liability*: While this may not be an option in a normal budget year, given the possibility of an influx of significant federal dollars on a one-time basis, this option warrants serious consideration. This is a prudent use of one-time dollars as it directly reduces liabilities and the associated funding burden both in the current and future budget years, which will continue to pay dividends into the future. Additionally, this would not adversely affect beneficiaries, the ability of the pension to retain and attract qualified employees, nor the broader Vermont economy.
2. *Assuring sustainable funding of the ADEC*: The increase in liability is calculated over the window of the actuarial valuation (30 years). It is incongruent with the timeframe that the unfunded liability represents to reduce it to the prior amount in a single budget year. Rather, more attention should be focused on creating funding stability for the ADEC in full this year and in future years. Doing so ensures that the unfunded liability will be retired as scheduled in 2038, while reducing the plethora of negative impacts associated with benefit reductions. Some options include finding dedicated

revenue or increasing employee contributions. I would encourage the legislature to explore these options to the fullest extent before entertaining benefit reductions. And as a matter of fairness, shouldn't employees be asked to what degree they are willing to pay more for the existing level of benefits, before making a determination that benefits should be reduced?

3. *Benefit reductions:* This immediately reduces liabilities and thereby the funding burden, but also brings many negative impacts, and therefore should be considered as a last resort. First and foremost, benefit reductions jeopardize the retirement security of people who have largely dedicated their career to public service. Benefit reductions can't be simplified to numbers on a page. Their effect on the lives of Vermonter's needs to be understood and appreciated. Benefit reductions are also likely to adversely affect the appeal of the pension to current and prospective employees, driving current employees into retirement and affecting the recruitment of employees in the future. The associated workforce challenges need to be understood. Additionally, there is an actuarial cost to the system of members retiring earlier than anticipated that could mitigate the projected savings associated with the benefit reductions, meaning less bang for the same amount of impact. The financial impact associated with increasing retirement rates beyond the actuarial assumed rates should be understood. Finally, about 70% of each dollar paid out in pension benefits accrues from investment returns. Reducing dollars going into the system now, will reduce future economic activity. This broader economic impact of benefit reductions should also be assessed.

Given the negative impacts associated with benefit reductions, I'd strongly encourage the legislature to consider a two-step process, in which actions for which there broad consensus can be reached move forward first and any benefit reductions be the focus of a study committee where the costs and benefits can be understood and properly weighed by the legislature. Benefit reductions are the most difficult conversations, but that shouldn't be a reason for not having them to the fullest extent necessary to understand the implications of and build buy-in around any reductions that may be necessary.

Thank you for consideration of my comments. I would also welcome the opportunity to discuss this testimony further and can be reached at ericpauldavis@gmail.com.

Respectfully,

Eric Davis