VERMONT LEGISLATIVE
Joint Fiscal Office
1 Baldwin Street • Montpelier, VT 05633-5701 • (802) 828-2295 • https://ljfo.vermont.gov
Issue Brief
February 20, 2025
Chris Rupe, Associate Fiscal Officer

How Vermont Funds the Employer Share of Public School Retirement Benefits

Executive Summary

Vermont funds the annual contribution requirements for retirement benefits for public school employees through the State budget, local school budgets, and contributions from members. The funding structure differs between pension and health care, as well as between teachers and non-teaching staff *(see Table 1)*.

Teacher pension and retiree health care benefits through VSTRS are paid primarily from the General and Education funds and are minimally reflected in local school budgets.

Pension benefits for non-teaching school staff who participate in VMERS are funded directly through local school budgets.

- Employer pension costs for most teachers are paid from the State budget (Eduction and General Funds) and are not reflected in local school budgets. Teachers in active service also contribute toward pension costs.
- Employer pension costs for non-teaching school staff are paid directly by local schools and are reflected in local school budgets. Staff in active service also contribute toward pension costs.
- Health care benefits for retired teachers are paid for primarily from the State budget, although a small share of the cost is funded through local school budgets via the "new teacher assessment." Members in active service do not contribute toward retiree health care, but instead pay a share of the premiums once enrolled in health care in retirement.

Table 1: **Summary of Employer Funding for Public School Retirement Costs**

Reflected in School Budgets	**Not Reflected in School Budgets**
VSTRS Teachers' Pension: • Employer cost for federally funded teaching staff are paid by local schools from federal funds *(toward normal cost and unfunded liability)* **VMERS Non-Teaching Pension** (if participating) • Employer cost is assessed at a stated percentage rate of covered active payroll. **Any Other Retirement Benefits Offered to Employees**	**VSTRS Teachers' Pension:** • Employer Normal Cost (Education Fund) • Unfunded Liability Payment (General Fund) *Both costs are net of contributions from local schools for federally funded teaching staff.*
VSTRS Teachers' Health Care (OPEB): • "New Teacher Assessment" *(toward normal cost and unfunded liability)*	**VSTRS Teachers' Health Care (OPEB):** • Employer Normal Cost (Education Fund) • Unfunded Liability Payment (General Fund) *Both costs are net of contributions from the New Teacher Assessment.*

The State budget apportions the employer costs for teacher retirement to the Education and General funds based on the purpose of the payments:

- The employer share of the normal cost is mostly paid from the Education Fund. Similar to salary or other benefits offered to the current active workforce, the normal cost represents the cost of compensating today's active workforce by prefunding the future benefits they accrue while they work. The employer (Education Fund) pays the net of the total normal cost and administrative expenses, minus contributions from active employees. For fiscal year 2025, $55.1 million of normal costs for both pensions and retiree health care for members of the Vermont State Teachers' Retirement System (VSTRS) are paid directly from the Education Fund—these costs are not reflected in local school budgets.
- The unfunded liability is mostly paid for by the General Fund. The unfunded liability reflects the impact of prior years' actuarial losses and underfunding, and is paid off through annual amortization payments that reflect both prinicipal and interest. In fiscal year 2025, the General Fund is paying $210.4 million for both pension and health care unfunded liabilities for VSTRS.

What are Retirement Benefits?

Pension Benefits

Most full-time public school employees in Vermont have the ability to participate in defined benefit pension systems through the Vermont State Teachers' Retirement System (VSTRS) and the Vermont Municipal Employees' Retirement System (VMERS).[1] After a five-year vesting period, members are entitled to a future annuity benefit upon reaching retirement eligibility. The benefit is defined by a formula that considers average final compensation, years of service credit, and a benefit multiplier (e.g., 1.67% for most teachers). For example, a teacher in VSTRS Group C who works for 20 years, earns an average final compensation of $90,000, and retires at age 65 will earn an annual benefit of approximately $30,060 (20 years x $90,000 x 1.67%), subject to survivorship elections, based on the Group C benefit formula. This benefit is then subject to cost of living adjustments tied to 50% of the net percentage increase in the Northeast Region Consumer Price Index (CPI-U), up to a statutory maximum.[2]

VMERS members, including many non-teaching school staff, receive similarly structured pension benefits. However, the benefit formula differs from teachers in VSTRS and varies among the four different VMERS groups.[3] In addition to defined benefit pensions, VMERS also offers a defined contribution plan to participating municipal employers, with a 5% employer contribution plus 1% employer-funded administrative cost. VMERS also offers a 457 deferred compensation plan, which is fully funded by participating members.

Other Post-Employment Benefits (OPEB)

Teachers in VSTRS can earn subsidized health care benefits in retirement (referred to as Other Post-Employment Benefits or OPEB). Eligible retirees can access health insurance with a subsidized premium, the value of which varies by years of service. Generally, members with at least 15 years of service receive a 60% subsidy, members with 20 to 24.99 years of service receive a 70% subsidy, and members with at least 25 years of service receive an 80% subsidy plus spousal coverage eligibility. VMERS does not offer a similar subsidized health insurance benefit to its members.

---

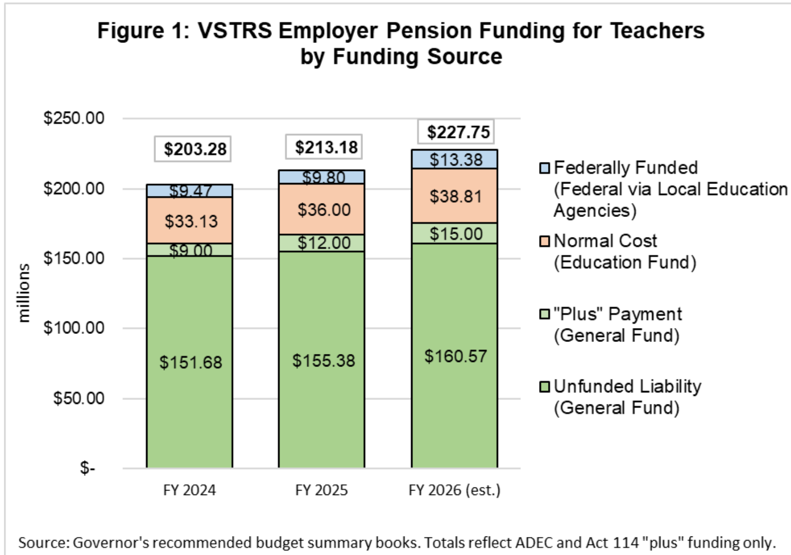
[1] This issue brief focuses on the VSTRS and VMERS retirement systems. There are, however, some school districts (e.g., Burlington, Rutland City) that offer retirement benefits through other systems, and not all school districts participate in VMERS. The employer costs for participating in other systems are reflected in local school budgets.
[2] See 16 V.S.A. § 1949
[3] See 24 V.S.A. § 5055

How Retirement Benefits are Funded

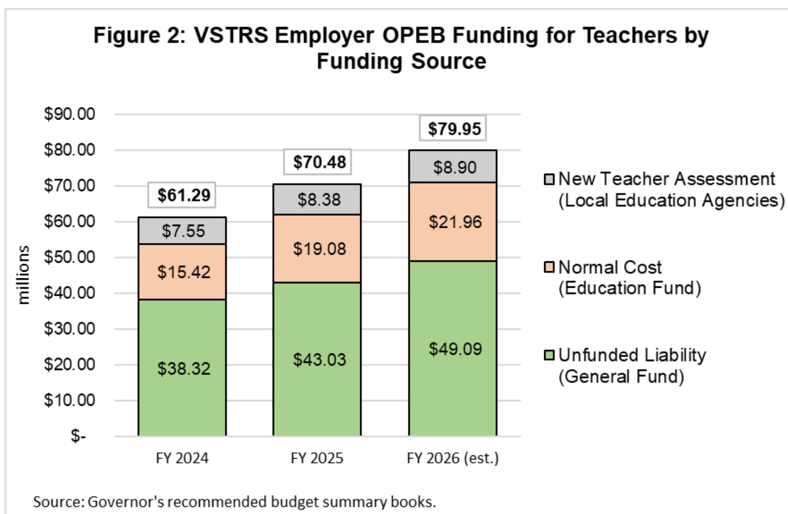
Pensions and OPEB each represent significant long-term liabilities to the State and local school districts that must be funded on an ongoing basis for decades.

In fiscal year 2025, employer costs for teacher retirement totaled $283.66 million, of which $265.49 million was funded through the State budget and the reminder from local schools. The State budget appropriated $203.38 million for pensions and $62.11 million for OPEB, across the General Fund ($210.41 million) and Education Fund ($55.08 million) – *see Figures 1 and 2.*

Pension and OPEB benefits are prefunded—funds are contributed to the retirement systems while members are in active service, those contributions are invested, and the assets fund future benefits to plan members and their beneficiaries. By leveraging investment gains compounded over time, prefunding is more cost effective to taxpayers over the long term.



Until recently, although pension benefits had been prefunded, OPEB were funded primarily on a pay-as-you-go basis with minimal prefunding. After the passage of Act 114 (2022), Vermont now prefunds OPEB for both retired teachers and State employees. At the time of Act 114's passage, JFO estimated that adopting a prefunding strategy reduced long-term teacher OPEB liabilities by $836.8 million. However, prefunding requires higher contributions in the near term than funding benefits on a pay-as-you-go basis.



Under current law, public school retirement costs are funded as follows:

- The VSTRS teacher pension system is funded by contributions from active members, and direct appropriations through the State budget from the General and Education funds. The portion of these costs paid by the Education Fund (the normal cost) is appropriated "off the top" and is <u>not</u> reflected in local school budgets. Local schools with federally-funded teaching staff pay for the pension benefits of those members from those federal funds.
- The VSTRS teacher OPEB system is funded primarily through direct appropriations from the General and Education funds. Local school budgets, however, do pay a portion of OPEB costs through an annual "new teacher assessment" on teachers first hired into the VSTRS system on or after July 1, 2015. This

assessment, which is adjusted for inflation, is $1,542 per applicable teacher in fiscal year 2025. Members do not make contributions toward OPEB while in active service; instead, they pay a share of the premium cost (20% to 40%) once enrolled in health care benefits in retirement.

- The VMERS pension system is funded by participating employees and employers, not directly through the State budget. The employer pension costs of non-teaching school staff who participate in VMERS, as well as for any other retirement benefits offered outside of VSTRS, <u>are</u> reflected in local school budgets. For VMERS, these employer pension costs range from 5.5% to 8.75% of payroll in fiscal year 2025, depending on pension group, and are expected to increase by 0.25% per year through fiscal year 2030.

Normal Cost, Unfunded Liabilities, and the ADEC

There are two major costs for pensions and OPEB that are actuarially calculated each year and must be fully funded in order to avoid underfunding these benefit systems – the <u>normal cost</u> and the <u>unfunded liability payment.</u> The <u>actuarially determined employer contribution (ADEC)</u> represents the total amount that the employer must pay each year in order to fully fund these two costs according to actuarial assumptions.

Normal Cost

The normal cost represents the portion of projected future benefit costs that are attributed to the current plan year. In simple conceptual terms, this represents the amount that must be paid into the respective benefit systems each year to fund the future retirement benefits earned by the active workforce that year, plus administrative costs. Put another way, the normal cost generally represents today's cost of providing future retirement benefits to today's workforce.

The normal cost is calculated based on actuarial assumptions and the demographic characteristics of the active workforce. The normal cost is often expressed as a percentage of active payroll that, if funded over the course of a member's career, will be sufficient to fund their average expected benefit in retirement. If the normal cost is not fully funded, the shortfall is reflected in the unfunded liability and must be amortized and paid back to the benefit fund (with interest) over time. Note that the normal cost represents an actuarially estimated average value across the entire membership based on long-term assumptions about inflation, investment gains, mortality, salary growth, retirement and turnover behavior, health care cost trends, etc. In reality, different benefit formulas and the behaviors and experiences of each member will translate into significantly different actual impacts to the retirement funds from member to member, and decisions made at the local level (e.g., salary levels, net turnover and retirement behaviors) can further impact overall statewide costs. Under Vermont's actuarial methods, the normal cost would be expected to increase in dollar terms each year, correlated with overall payroll growth.

To fund the pension normal cost and administrative expenses, active teachers in VSTRS pay pre-tax pension contributions that are credited toward the normal cost, but those contributions do not fully fund the total normal cost. In other words, this is the "employee share." The remainder of the pension normal cost not funded by teacher contributions is paid directly "off the top" from the Education Fund and is <u>not</u> reflected in local school budgets (except for federally funded staff as noted elsewhere). In fiscal year 2025, teachers in active service are projected to pay $54.7 million from contributions that range from 6.15% to 7.35%, depending on their salary.[4] The Education Fund will pay $35.98 million and federal funds, through local

[4] See 16 V.S.A. § 1944 (b)(2)(B)(iii)

education agencies, will pay the remaining $1.84 million to fully fund the remainder of these costs.

OPEB normal costs are similar to pension normal costs and are also funded "off the top" of the Education Fund (except for the "new teacher assessment"). However, active teachers do not make contributions toward OPEB normal costs. Rather, teachers pay a cost share of their insurance premiums once they are in retirement and enrolled in those health care benefits. In fiscal year 2025, $19.08 million was appropriated from the Education Fund to the Retired Teachers' Health and Medical Benefits Fund to fund the OPEB normal cost for teachers – this cost is not reflected in local school budgets.

Unfunded Liabilities

The normal cost, in theory, should be sufficient to fully fund accruing benefits and administrative costs from year to year. However, reality from year to year does not perfectly mirror the long-term actuarial assumptions that the normal cost is based upon. For example, inflation might drive salaries and cost of living adjustments higher, investments might not perform as well as expected, or retirement and turnover patterns may change from year to year. Furthermore, those long-term actuarial assumptions may change over time – for example, lowering the assumed rate of investment return – or employer contributions may be insufficient (through either inadequately funding the ADEC or funding benefits on a pay-as-you-go basis).

Table 2: **Funded Status of State Public School Employee Retirement Systems (FY 2024)**

$ millions

Teachers	
VSTRS Pension	
Accrued Liabilities	$4,602.3
Less Actuarial Value of Assets	$2,815.3
= Unfunded Liability	$1,787.0
Funded Ratio (Assets/Liabilities)	61.2%
VSTRS OPEB	
Accrued Liabilities	$974.5
Less Assets	$113.2
= Unfunded Liability	$861.3
Funded Ratio (Assets/Liabilities)	11.6%
Non-Teaching Staff	
VMERS Pension (all groups, not just school staff)	
Accrued Liabilities	$1,371.4
Less Actuarial Value of Assets	$1,015.4
= Unfunded Liability	$356.0
Funded Ratio (Assets/Liabilities)	74.0%

The unfunded (or net) liability is the shortfall between the present value of the accrued liabilities (the projected cost of benefits owed to the current membership) and the actuarial value of the assets on hand to pay for those liabilities. As of the end of fiscal year 2024, **Vermont's unfunded retirement liabilities for teachers (for pensions and OPEB combined) totaled more than $2.6 billion** – see *Table 2*.

The unfunded liability represents, in practice, a long-term debt that must be paid off through higher annual contributions into the retirement funds, unless it can be paid for through some other factor (e.g., unusually strong investment returns or other actuarial gains). The unfunded liability effectively accrues interest at the systems' assumed rate of return (currently 7%) to account for forgone assumed potential investment gains. The unfunded liability amortization payments are currently calculated to grow at 3 percent year over year, similar to assumed payroll growth rates, and be sufficient to fully pay off the unfunded liability plus interest by 2038 for pensions and 2048 for OPEB. These costs are recalculated annually in the actuarial valuations based on the plan experience during the prior fiscal year.

The VSTRS teacher pension and OPEB unfunded liability amortization payments are made primarily from the General Fund. In fiscal year 2025, the actuarially determined amortization payments budgeted to the General Fund were $155.38 million for pensions and $43.03 million for OPEB.

"Plus" Payments: Paying less than the actuarially detemined employer contribution (ADEC), when all else is equal, will increase the unfunded liability and, in turn, increase the payments needed to fully fund the retirement systems in future years. Conversely, paying more than the ADEC will accelerate payment on the unfunded liability balance and save interest costs in future years. This puts downward pressure on future ADEC payments on a two-year lag, reducing the growth in future amortization payments and creating capacity in future budgets.

In recognition of this, the General Assembly enacted in Act 114 (2022) a policy of funding above-ADEC payments toward the VSTRS teacher and VSERS State employee pension systems. These "plus" payments are made in addition to the actuarially determined amortization payments to accelerate the pay-down of the unfunded liability. These payments, which are $12 million per pension system in fiscal year 2025 and $15 million in fiscal year 2026 and beyond, are to continue until each pension system respectively reaches 90% funded (expected to occur in fiscal year 2035 for VSTRS). The "plus" payments are made from the General Fund and will reduce the rate of growth in pension costs on the General Fund in future years while saving taxpayers interest costs.

Exceptions

The vast majority of employer retirement costs for teachers are paid as described above. However, there are two notable exceptions:

- Pensions for Federally-funded Teaching Staff: Rather than apportioning the employer pension costs between the Education and General funds as described above, the pension costs for federally-funded teaching staff are paid directly by Local Education Agencies (LEAs) from those federal funds. This cohort represents a relatively small share of total teacher employer pension costs, estimated to be $9.8 million for fiscal year 2025. Those payments go toward the normal cost ($1.84 million) and unfunded liability ($7.96 million) and offset costs that would otherwise fall to the Education or General funds, respectively.

- OPEB New Teacher Assessment: Schools pay a flat annual amount indexed to inflation for each teacher first hired into the VSTRS system on or after July 1, 2015.[5] For fiscal year 2025, this amount is $1,542 per applicable teacher and is estimated to generate approximately $8.38 million. These funds go toward the normal cost ($2.57 million) and unfunded liability ($5.8 million) and offset costs that would otherwise fall to the Education or General funds, respectively. This assessment is the only means by which OPEB costs are reflected in local school district budgets, and represents a relatively small share (11.9%) of the $70.48 million total OPEB ADEC for fiscal year 2025.

Pension Benefits for Non-Teaching Staff

Many (but not all) non-teaching staff employed by schools participate in VMERS, not VSTRS. In contrast with the VSTRS system for teachers, VMERS pension benefits are fully funded by participating employers and employees – not directly through the State budget. Employer pension costs for non-teaching staff,

[5] See 16 V.S.A. § 1944d

therefore, are reflected in local school district budgets, which are ultimately paid for through the Education Fund. These costs vary significantly by school, but few school employers participating in VMERS pay more than $400,000 annually, and most pay significantly less than that.[6]

Rather than apportioning VMERS normal costs and unfunded liability payments across different major funds and directly appropriating these costs, VMERS members and employers pay contributions at established percentages of payroll that vary by employee group. In fiscal year 2025, employer costs range from 5.5% to 8.75% of payroll, depending on pension group.

While VSTRS ADECs have been fully funded in recent years, the VMERS pension ADEC has not been adequately funded. The funded ratio for VMERS has therefore dropped; the system was 74.0% funded at the end of fiscal year 2024. Employer and employee contributions are each scheduled to increase by 0.25% per year through fiscal year 2030 in an effort to improve the funding situation and bring it closer to actuarial recommendations. Actuarial projections suggest that this increase should bring the funded ratio above 80% in the 2030s.

Note that employer retirement costs for schools that participate in systems other than VSTRS and VMERS (e.g., Burlington, Rutland City) are reflected in local school budgets, and are not directly funded by the State budget.

Considerations for Legislators

1. **The current funding structure for public school retirement is complex and different for teachers and non-teaching staff.** Some of this complexity reflects choices made over prior decades as different benefit systems were established (e.g., establishing the VMERS pension system), or funding policies were adopted (e.g., establishing the Education Fund, prefunding teacher OPEB). Currently:

    a. Pension and OPEB benefits for teachers are mainly funded at the State level and minimally reflected in local school budgets. The Education Fund generally pays for the employer normal cost to fund benefits for today's active teachers, and the General Fund generally pays for the unfunded liability.
    b. Retirement benefits for non-teaching staff, and any other retirement benefits not offered through VSTRS, are funded in local school budgets.

2. **The General Fund currently bears the majority of the cost burden of teacher retirement benefits.** Under the current funding structure, the employer cost of providing future benefits to today's active teachers is paid primarily "off the top" of the Education Fund ($55.1 million in fiscal year 2025), a cost not reflected in local school budgets. The General Fund, meanwhile, pays for the much larger impact ($210.4 million) of addressing legacy underfunding and actuarial losses that accrued to the unfunded liability.[7] Legislators should be mindful of the significant cost the General

[6] See VMERS Schedule of Employer Allocations and Schedule of Pension Amounts by Employer (June 30, 2023): https://www.vermonttreasurer.gov/sites/treasurer/files/VMERS/PDF/2024/VMERS%20GASB%2068%20Signed%20Final%20Audit%20Report%20FY23.pdf

[7] From fiscal year 1979 through fiscal year 2007, the VSTRS employer pension contribution was underfunded in all but four years. The impact of this legacy underfunding, however, is responsible for a small share (approximately 1/6th) of the total unfunded liability balance. The vast majority of the unfunded liability is due to changes to actuarial assumptions and experience deviating from those

Fund currently bears to fund these costs related to the education workforce, as well as the capacity of the General Fund to bear any greater shares of these substantial expenses.

3. **Although VSTRS employer pension costs are mainly funded at the State level, those costs are influenced by local decisions.** When all else is equal, a school hiring a teacher at $80,000 will have a different impact to the pension fund than a school hiring a teacher at $50,000. However, since these costs are aggregated and paid "off the top" of the Education Fund, they are not proportionally reflected in the actual personnel budgets of local schools. However, transitioning to a model that reflects these costs in local school budgets would likely be more administratively burdensome than the current method of appropriating funds directly through the State budget. For example, if pension normal costs were assessed to local schools as a percentage of payroll (similar to how VMERS is currently funded), there would be more risk of error in over/underfunding the ADEC since they would be calculated on projections of locally-controlled staffing and payroll estimates that could change over time. There could, however, potentially be alternative methods of proportionally reflecting employer normal costs in local school budgets. Additional complexity could also arise from requiring schools to remit pension payments to the VSTRS system, and then auditing these payments for compliance, rather than appropriating costs on a one-time basis from the Education Fund through the State budget. Legislators should carefully explore administrative complexities, and seek to understand any potential unintended consequences, if they consider modifying the funding system to reflect costs locally.

4. **While the VSTRS systems are being funded to (or in excess of) actuarial recommendations, the same is not true of VMERS.** In fiscal year 2024, the VMERS ADEC across all groups was 12.37% of payroll but was only funded at 7.25%, on average. VMERS pension contribution rates will gradually increase by 0.25% per year for both employees and employers in future years until fiscal year 2030, which is projected to increase VMERS' funded ratio but will also gradually increase budgetary pressures on participating municipal and school employers, which in turn will increase pressure on the Education Fund.

Appendix: Resources

- VSTRS: https://www.vermonttreasurer.gov/vstrs
- VMERS: https://www.vermonttreasurer.gov/vmers
- Act 114 (2022): https://legislature.vermont.gov/bill/status/2022/S.286
- Pension Benefits, Design, and Funding Task Force (2022):
    - Report: https://ljfo.vermont.gov/assets/Subjects/Pension-Task-Force-Report/82821b1335/Pension-Task-Force-Final-Report.pdf
    - Materials: https://ljfo.vermont.gov/subjects/pensions-and-state-debt/pension-task-force-report

assumptions (e.g., investment losses from Great Recession, net turnover and retirement behaviors, reducing the assumed rate of return). The prior practice (pre-2015) of paying for VSTRS OPEB on a pay-as-you-go basis from the VSTRS pension system also had a detrimental impact to the funded status of the VSTRS pension system, with a similar effect as underfunding. For more details, see the Pension Benefits, Design, and Funding Task Force Report (2022).