The University of Connecticut Chapter of

AAUP

THE AMERICAN ASSOCIATION OF UNIVERSITY PROFESSORS, INC.

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Testimony regarding H.B. 7118 "An Act Funding the Unfunded Pension Liability Portion of the Fringe Benefit Cost for Certain Employees of the Constituent Units of the State System of Higher Education"

Co-Chairs Haddad and Haskell, Ranking Members Hall and Hwang, Vice Chairs Flexor and Turco, and esteemed members of the Higher Education and Employment Advancement Committee,

My name is Tom Bontly. I am a faculty member in the Philosophy Department at the University of Connecticut and currently serve as President of the UConn Chapter of the American Association of University Professors (UConn-AAUP).

Thank you for this opportunity to speak to H.B. 7118, which I urge you to support.

We all know that Connecticut has a significant problem with accrued unfunded liability, including both pension liability and retiree health care liability. This debt is the legacy of *decades* of chronically underfunding these plans. The cost of making up for these unfunded liabilities is causing difficulties throughout state government, but nowhere more than in higher education.

Currently, a big chunk of the payment on this debt is passed to the state's institutions of higher education in the form of artificially inflated fringe benefit rates. According to information provided by the UConn's Chief Financial Officer, the fringe benefit rate for employees in the State Employee Retirement System (SERS), as set by the Comptroller, is currently 96.4% of salary. Out of that 96.4%, a whopping 33.61% goes just to pay down the SERS plan's unfunded liability, and another 20.94% goes to cover unfunded liabilities for retiree health care program.

For comparison, the *actual* cost of pension benefits for employees in SERS is 5.3% of salary, and the *actual* cost that employee's post-retirement health benefit (what are referred to as "OPEBs") is 2.86% of salary.

Together, then, the charge for unfunded liability adds up to 54% of the employee's salary, or just over 56% of the fringe rate. (The remainder covers the actual cost of retirement benefits, plus the employer contribution to health insurance, FICA, and so on.) In other words, more than half of the fringe benefit rate which the university pays on SERS-participants has *nothing whatsoever* to do with the real cost of their benefits.

For most state agencies, the artificially inflated fringe rates are inconsequential, because their operations are funded by the state itself. But for the state's colleges and universities, which rely increasingly on non-state support, these bloated fringe rates create numerous difficulties.

First, inflated fringe rates drive up the cost of educating our students. While the UConn administration does what it can to avoid passing the unfunded liability charge to our students, in reality, the University is often left with a choice: hire fewer instructors, in which case students can't get the courses they need to graduate; or raise tuition. Either way, the students wind up paying more.

In essence, the state of Connecticut is levying a hidden tax on students and their families, making our children pay for the sins of the past. This arrangement is unjust. The unfunded liability was not created by these students, nor by our institutions of higher education. It was created by the state as a whole: by past legislators and governors who chose to underfund the retirement benefits they were promising, and ultimately by the voters who elected them. And the state as a whole benefited (at least temporarily) from those choices: for by neglecting to save money for future retirements, the state was able to spend that money on government services and infrastructure while still keeping tax rates low.

Since the state as a whole created the unfunded liability problem, and since the state as a whole reaped the benefits, it is only fair that the state as a whole pay the bill. So, if taxes must now be raised to pay for the sins of the past, those taxes should not fall disproportionately on students and their families: they should fall on all of us.

Beyond the injustice, however, the current policy is inefficient and counterproductive. In particular, the inflated fringe rates drive up the cost of doing research at the state's flagship university, making UConn's researchers less productive and less competitive for federal grant money. Grant awards are typically capped, meaning that granting agencies (e.g., NIH) generally do not increase the size of an award to cover the state's high fringe. Instead, it comes out of the researcher's budget, with the result that he or she can hire fewer people to work on sponsored projects. Fewer people means that less work gets done, which means fewer discoveries, fewer inventions, fewer publications, and fewer grant applications going out the next funding cycle. And those grant applications that do go out are less competitive, because the granting agencies know that they will get more research for their money if they give it to another institution.

How much less competitive is UConn for grant funding these days? I do not know precisely, but a comparison with the fringe rates of other, comparable institutions is instructive. According to numbers provided by CFO Scott Jordan's office, the average fringe rate on UConn faculty runs about 20 percentage points higher than it does on average at UConn's peer and aspirant institutions. The average fringe rate on non-faculty professional staff at UConn runs about 30 percentage points higher than average.

Very roughly, then, a grant which supports 3 staff members at UConn would support 4 at one of our competitors and produce proportionally more research work. Granting agencies know this, by the way, and it factors into their decision-making. While it is hard to be certain, I would guess that these numbers are a big part of the reason why UConn's grant awards and expenditures have been basically flat since 2011, after many years of growth.

The impact of this problem on the state should be obvious. Inflated fringe rates mean less grant revenue – probably tens of millions of dollars less grant revenue per year. Less grant revenue means fewer laboratory jobs for CT residents to fill, fewer patents and start-ups, and generally less capacity for UConn to serve as an economic engine for the state.

In his written testimony on this bill, Comptroller Lembo, while certainly recognizing the problem our institutions of higher education face, raises certain concerns about whether the best solution is to remove the unfunded liability surcharge on the fringe rate, or whether it would be better instead to provide these institutions with additional state support to cover the differential. These questions are important, and we are eager to work both with Comptroller Lembo and our elected representatives to find the best solution.

While my testimony has been concerned with the effect of inflated fringe rates on our institutions of higher education, it should be recognized more generally that the practice of larding debt payments onto fringe benefit rates has other negative consequences.

From an accounting standpoint, the practice is highly misleading. It gives the good people of Connecticut the mistaken impression that current state employee benefits are exorbitantly expensive. They are not. As highlighted above, the actual cost of current employees' retirement benefits is only 8% or so of salary. The surcharge for unfunded liability is 54%. Again, that surcharge has nothing whatsoever to do with the cost of current state employee benefit plans. Rather, it goes to fund benefits for those who are retired or soon-to-retire, those in Tier I of SERs, whose benefits were never pre-funded. (Incidentally, Tier I is *not* the product of state employee collective bargaining, which it predates.) Now that bill is coming due, and the state has for whatever reason taken to hiding that bill in the fringe rate on current employees.

The current practice is akin to taking someone's accrued credit card debt (or mortgage debt, etc) and adding it to their utility bill. Such a practice would undoubtedly make folks think their utility rates were outrageously high. They might look for another electricity supplier or even think about shutting off their electric altogether. But their electricity usage isn't the problem; it's the unrelated debt payment, which will have to be paid whether they shut off their utilities or not.

The practice of hiding the state's debt payments in its labor costs creates other <u>perverse incentives</u>. For instance, there is a perception that the state could save considerable money by privatizing or partially privatizing UConn's John Dempsey Hospital. But the savings are illusory. Were we to privatize or even close Dempsey (moves I do *not* support), the unfunded liability would still be there, big as ever.

Similarly, there is a perception out there that we could solve the high fringe problem by renegotiating the SEBAC agreement, which set pension and health benefits through 2027. For instance, I have heard it suggested that we could solve the problem by moving state employees into a 401k-style plan, such as the Alternative Retirement Plan open to employees in higher ed. After all, the fringe rate for the ARP is only 54.12% of salary, compared to 96.4% for SERs, right?

Sadly, no. The difference is due entirely to the accrued unfunded liability. The fringe rate on SERs employees includes a surcharge of 54.55% for unfunded liability, whereas the surcharge on ARP is a mere 3.89% to make up for past underfunding of retiree health benefits. So, were the state to move all employees into the ARP, fringe rates would go down, but the unfunded liability would be there, big as ever. The state would simply have to account for it another way, which it could do without moving anyone to the ARP, simply by removing the surcharge from SERS fringe rates and accounting for the debt payment another way.

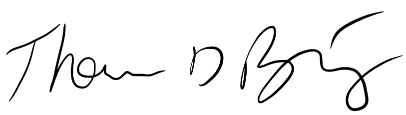
Indeed, moving state employees from SERS into the ARP (*if* you could even get SEBAC to agree to such a change, not to mention the IRS) would actually be counterproductive. When you look at the *actual* cost of employees' retirement benefits, SERS is actually quite a bit cheaper than ARP: 5.41% of salary for SERS compared to 7.44% for ARP (as of FY 18 – these numbers have both gone down slightly for FY 19 due to the SEBAC 2017 agreement). Why is SERS cheaper? Because the state assumes all of the investment risk; to get employees to assume the risk, as they do in the ARP, you have to give them an incentive.

So, including the cost of unfunded liability in the fringe rate for current employees creates a perverse incentive: it tells people that the state could save money by transferring state employees from SERS to the ARP, when the opposite is true. There are other problems with such a proposal. For instance, if the state wanted to eliminate SERS altogether and transfer current employees *retrospectively* into the ARP, it would have to pre-fund the retirement benefits they would have earned had they been in the ARP since their date of hire. Doing so would require billions of dollars which the state does not have.

Through a combination of bad luck and bad policy, Connecticut has accumulated a lot of pension debt. There is no easy fix, but at least we could stop shooting ourselves in the foot, which is precisely what we do when we inflate the fringe rate paid by our researchers. For these reasons, I hope that you will support H.B. 7118 and help us find a more rational mechanism for managing the state's accrued unfunded retirement liability.

Thank you for all your efforts on behalf of higher education in Connecticut.

Sincerely,



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