# Explanation of the New Breakpoint Agreement

## I. Background

Typically pension plans seek to produce replacement income so that when a worker retires, he or she can live as comfortably as they were when they were working. (Most experts say that is supposed to be about 70% of the workers' income while active, counting pension, social security, and income from savings). When defined benefit plans like SERS were created, one of the things taken into account was that on some of a worker's salary he or she would receive social security benefits upon retirement, but there is a social security maximum. For any salary earned over the maximum, the worker doesn't receive social security. In 2013, the maximum for social security is $113,700. So the social security benefit for someone earning exactly $113,700 would be the same as for someone with the salary of a million dollars. The theory is that people should get a higher pension multiplier for the income above the social security maximum and a lower multiplier for the salary below the social security maximum because they need their pension to replace more of their income once the social security maximum is reached. (A pension multiplier is a percentage which is multiplied by years of service and final average salary to produce a yearly pension. Pension multipliers outside of hazardous duty plans typically range from about 1% to about 2%. So a simple example of how a multiplier works would be a 1% multiplier which for people with 30 years of service would produce a pension equal to 30% of their final average salary).

All SERS plans except for hazardous duty plans include a breakpoint. Tier 1 was created by statute in 1939 and included a breakpoint which was fixed by statute, and was raised by the General Assembly several times before it reached its final amount of $4,800 in 1956. So Tier I has a fixed breakpoint of $4,800 with a lower multiplier for salary below $4,800 and a higher multiplier above that. (The breakpoint for Tier 1 was and is implemented upon the receipt of a normal social security benefit, now age 66).

When Tier II was created in 1981 (because of various pension negotiations that took place in the early 1980's the actual date of implementation could have been delayed as late as July 1, 1984), the parties agreed that it, like Tier 1, would include a breakpoint. (The breakpoint for Tiers 2a and 3 is the same as the one for Tier 2). The multiplier for income below the breakpoint was set at 1 and 1/3% (about 1.33%). For income above the breakpoint, it was set at ½% higher, or 1 and 5/6% (about 1.83%). However, the bargaining parties disagreed aboutwhether the new breakpoint should be fixed or variable. The unions sought another fixed breakpoint, while the State sought one that increased with the cost of living which at that time had been rising by nearly 20% annually. A compromise was reached and the Tier II breakpoint was agreed to go up 6% each year. However, the experience in the 1980s was that inflation slowed, and the unions felt the breakpoint was increasing too quickly. When the parties negotiated again in 1988 it was agreed that the breakpoint would have a new "stop gap." The language of the stop gap is a little complicated – it reads: "The breakpoint for any particular year shall not exceed average covered earnings for social security purposes for an individual attaining age 65 in that year and assuming a full 35 years of coverage under the social security systems." Put together, this means that the breakpoint goes up by 6% each year but is not allowed to go higher than the stop gap.

The stop gap has not yet been hit, and the result of this is that each year since 1981, the breakpoint has been going up at 6% a year, and since over time salary increases have not in general kept up, more of members' salaries for pension computation purposes has been subject to the lower multiplier. The breakpoint is now $65,300, which means that many workers have all of their pensions computed using the lower below breakpoint multiplier, and even workers whose salary is greater than the breakpoint still have a large part of their pensions' computed using the lower below breakpoint multiplier. On a percentage basis, the impact is greatest on lower paid workers, but the negative impact affects everyone.

When the parties engaged in the discussions that lead to SEBAC 2011, the administration, of course, had cost savings as its primary goal. The unions' primary goal was to extend the pension and healthcare agreement, but they had a number of secondary goals, one of which was to try in some way to address the breakpoint. A number of ideas were exchanged in those discussions, but eventually it was agreed that beginning in 2013, once the immediate financial and budgetary crisis was over, the State would set aside ½% of payroll(or approximately $35 million dollar on an annualized basis) to improve the breakpoint, particularly as it impacted lower paid workers. It was recognized that the ½% was not nearly sufficient to eliminate the breakpoint. But it was enough to help.

## II. The Breakpoint Bargaining

In 2013, the unions through SEBAC established a rank and file negotiating committee to consider how best to use the ½% set aside by SEBAC 2011. The Committee included a mix of newer and longer service workers as well as higher and lower paid workers, and the SERS plan's actuaries were engaged to provide analysis and figures. The committee adopted a set of principles that included trying to improve the situation for everyone, especially lower paid workers, and avoiding harming anyone. It also received from the actuaries the very important information that in approximately 2015, the breakpoint was predicted to hit the stop gap, and from then on the actuaries anticipated that it would increase by 4 to 4.5% per year, rather than 6%. Because the stop gap is effectively tied to a 35 year average of inflation, the percentage by which it increases varies very little on a year to year basis. This means that even without using any of the ½% of payroll, the yearly increase in the breakpoint will be moderated by the stop gap provision already in the agreement.

The Committee then studied several approaches to using the ½% of payroll, the two most prominent being using the money to slow the growth of the breakpoint, and using the money to increase the multiplier below the breakpoint. The Committee found that using the money to slow the growth of the impacts was less than ideal for four reasons: (1) ½% of payroll was not enough to actually freeze the breakpoint only to slow it; (2) slowing the growth of the breakpoint would do little or nothing for the lowest paid workers whose salaries are already below the breakpoint; (3) the breakpoint's growth is already scheduled to slow as a result of the stop gap, and the value of any further change the parties' negotiated would basically be another guess about the future of inflation; and (4) slowing the growth of the breakpoint would have a much bigger effect on newer workers than on those with more service, since the longer it is until retirement, the more years the breakpoint has to grow.

Using the money to increase the multiplier below the breakpoint worked better. The actuaries found that the ½% of payroll was enough to increase the multiplier below the breakpoint for all years of service (including those years*before* the July 1, 2013 effective date of the change) to 1.4% from its current 1 and 1/3% (or about 1.33). This means that all workers regardless of their years of service benefit from the change. And all workers regardless of their salary benefit from the change, since everyone has at least part of their salary below the breakpoint. Also, the improvement to the 1.4% multiplier is a *guaranteed* improvement – regardless of what happens to the cost of living, 1.4% is always higher than 1.33%. Finally, using all of the money to improve the multiplier below the breakpoint while leaving the higher multiplier above the breakpoint alone served the purpose of directing the improvement particularly at lower paid workers, even while making sure than no matter what the worker's salary, everybody gained. So the Committee recommended increasing the multiplier below the breakpoint to 1.4%, and leaving the multiplier above the breakpoint as it is (about 1.83%).

The Committee's approach was first presented to SEBAC Leadership, and then to the Administration, and a tentative agreement adopting that approach was reached on December 10, 2013. A final vote of SEBAC Leadership is expected at its next meeting in January. In the interim, each union will review the agreement. While it is up to each union exactly how that review will take place, because the ½% was already included in the SEBAC 2011 agreement which members' ratified, and because the change in the multiplier is an improvement and no member is harmed, it is expected that ratification for most if not all unions will be by their delegate body rather than full membership vote.

A chart showing the projected impact of the tentative agreement (taking into account the combined the moderation in the breakpoint increase already in the current agreement), is below. (To get a sense of the difference made by the change in the multiplier by the multiplier change alone, use just the 2013 columns):

| | ***Comparing Pensions Using the Current Multiplier to Proposed New Multiplier**** | | | | | |
|---|---|---|---|---|---|---|
| ***Final Average Earnings (as of 2013)*** | ***Retiring in 2013 Current Multiplier*** | ***Retiring in 2013 New Multiplier*** | ***Retiring in 2023 Current Multiplier with 6% Breakpoint Increase*** | ***Retiring in 2023 New Multiplier with 4% Breakpoint Increase*** | ***Retiring in 2033 Current Multiplier with 6% Breakpoint Increase*** | ***Retiring in 2033 New Multiplier with 4% Breakpoint Increase*** |
| **$50,000** | $19,995 | $21,000 | $29,597 | $31,085 | $43,812 | $46,014 |
| **$80,000** | $34,197 | $35,510 | $47,578 | $52,563 | $70,098 | $77,806 |
| **$110,000** | $50,694 | $52,007 | $71,997 | $76,982 | $101,125 | $113,953 |

* All computations assume 30 years of service and normal retirement age. Assumes average 4% annual salary increase in years beyond 2013. Also shows impact of the change from 6% to 4% in yearly Breakpoint increase already projected from current agreement.

## *III.* What's Next

If the 1.4% is ratified by the Coalition as a final agreement, it will be effective for all members with retirement dates on or after July 1, 2013. In addition, the Committee and SEBAC Leadership had during the breakpoint negotiations also explored adding a voluntary system by which members could contribute additional amounts to the pension fund in return for a higher multiplier for their pension. The administration has agreed to explore that idea in further informal discussions which are expected to take place over the next several months. Since this voluntary system would have no overall cost to the fund, it does not need to be resolved in order to determine how to best spend the 1/2% of payroll set out in SEBAC 2011.