CLEMSON
JIM SELF CENTER ON THE FUTURE
POLICY BRIEF

Policy Options for the South Carolina Retirement System

Holley H. Ulbrich, Senior Scholar
Jim Self Center on the Future
Strom Thurmond Institute
October 2011

Like many states in fiscal distress, South Carolina is rethinking the structure and fiscal health of its retirement system for state employees. The primary program of South Carolina's five state retirement systems[1] is a defined benefit rather than a defined contribution system. In addition, there are several optional defined contribution plans for supplemental retirement investment. In a defined benefit system, both employer and employee make regular contributions to the system prior to retirement. After a stated minimum number of years and/or combination of age and years, the employee is entitled to a pension for the rest of his/her life that is based on earnings, years of service, and in some cases, age at retirement.

Like Social Security, there is an insurance element in the state retirement system. Benefits are funded by employee contributions, employer contributions, earnings on the system's investments, and benefits not claimed by those who left the system without qualifying for benefits or who did not live long enough to recover their contributions.[2] Unlike Social Security, however, the state retirement system is not a pay-as-you-go system with today's retirees receiving checks funded by the contributions of current workers. Also unlike Social Security, the state retirement system is not structured so as to replace a higher percentage of earnings for low income workers. All retirees receive the same percentage of their earnings base.

The alternative to a defined benefit program is a defined contribution program, to which many private sector employees and some public entities have switched in recent decades. A defined contribution program is also usually funded by contributions from employees and employers, but there is no insurance element. Your pension will depend on what you and your employer contributed, how long you live in retirement, and how well the assets in your pension fund

[1] The state has several different systems which are somewhat similar: South Carolina Retirement System (SCRS), Police Officers Retirement System (PORS), General Assembly Retirement System (GARS), Judges and Solicitors Retirement System (JSRS), and National Guard Retirement System (NGRS). Because the South Carolina Retirement System (SCRS) is the largest, all statements about the state retirement system refer to SCRS.

[2] Employees who leave may recover their own contributions with interest but not the state's contribution unless they were one of the employees eligible for the alternative defined contribution program and elected that option.

perform. The risk of outliving one's assets, or of portfolio losses due to market fluctuations, falls on the individual. For workers who expect to move frequently from one employer to another during their careers, a defined contribution program is more portable. For workers who expect to have a long career with a single employer, the defined benefit program is usually more attractive.

Making Changes

Pensions are a part of a compensation package. A defined benefit program can be a useful tool to retain good state employees as they mature in their job and acquire skills that are job-specific or program-specific. It can also discourage the departure of other workers who are considering a move to a different non-state organization. When a state agency is looking for incentive packages to reduce the work force, or shift the composition of the work force to reflect changing needs, the defined benefit program can be a useful way of accomplishing that goal simply by purchasing the additional service credit needed to make retirement attractive.

The state is committed to funding the system on an actuarial basis with adequate reserves to ensure future payments. When circumstances change and the funds are no longer adequate over a 30 year time horizon to fund expected payments, the state may make appropriate changes in its program to ensure its financial viability. The state needs some flexibility to change the package as circumstances change, while the employees understandably would like stability so that they can plan for their career and retirement choices. Because these benefits are part of a contract, it is sometimes difficult for the state to change the system, particularly for longer-term employees.

Options for Change: Years of Service and Age

At present, workers at any age can retire in South Carolina with full benefits after 28 years of service. Our neighboring states of North Carolina and Georgia both require 30 years of service for workers under age 60. Workers 60 and older can retire in South Carolina and Georgia with 10 years of service (25 years in North Carolina). Workers 65 years and older in South and North Carolina can retire with five years of service, but in Georgia they need 10 years.

The required number of years for retirement with full benefits in South Carolina was reduced from 30 to 28 in the late 1990s. With the increases in life expectancy and the number of employees taking advantage of that option, the possibility of restoring the 30 year requirement is one option on the table that would increase the financial stability of the system. The minimum number of years of service to be eligible for a pension is called the vesting requirement, which is five years in North and South Carolina, 10 years in Georgia, and 10 years for Social Security.

Some states make exceptions to the number of years of service required for public safety and other employees in high risk or physically demanding jobs. Other systems, both public and private, use a combination of age and years of service. For example, a plan may allow retirement with full benefits when age and years of service add to 85. A worker would be eligible to retire at age 65 with 20 years of service, age 60 with 25 years of service, or age 55 with 30 years of service.

Options for Change: Early Retirement

Most systems make some provision for early retirement for those who are vested in the system. In South Carolina, a worker can retire at age 60 with at least five years of service, but the benefit is permanently reduced five percent for each year of age less than 65. Workers at age 55 or older can retire if they have at least 25 years of service, but the benefit is permanently reduced four percent for each year of service less than 28.

North Carolina takes into account both age and years of service in reducing benefits. Between ages 60 and 64, with at least 25 years of service, benefits are reduced from three percent to 15 percent depending on age and years of service. Retiring between the ages of 50 and 60 result in benefit reductions from five percent (age 50 with 29 years of service) to 50 percent (age 50 with 20 years of service).

Georgia's penalties are more stringent under age 60, with a seven percent penalty for each year of service under 30. In general, the penalties for early retirement are less stringent than in our neighboring states. Social Security also imposes penalties for retiring before age 67 at a rate of five percent a year regardless of the number of years of service. That change from age 65 to age 67 was phased in over a number of years. The penalty is adjusted on a monthly basis.

Options for Change: Benefit Levels

There are several areas in which changes in the benefit levels might be adjusted. One is the income base, which in South Carolina is the three highest consecutive years of earnings. In North Carolina the base is the highest four years, and in Georgia two years, with no raises greater than five percent in the final year counted as part of the base. Social Security uses 35 years of wage history, adjusted for inflation and omitting the five lowest years. There is an opportunity for some workers to maximize earnings in some state occupations over the last few years (for example, by professors teaching summer school, or dual employment) in order to increase pension amounts. A longer income history would make this kind of pension "padding" more difficult.

Another option for change is to adjust the percentage of the base paid in benefits, which is presently 1.82 percent in South Carolina (and also North Carolina: Georgia pays between 2 percent and 2.2 percent depending on years of service). That rate could be adjusted either upward or downward, but a downward adjustment might create some legal challenges for those who are already vested.

The contribution rate for the South Carolina Retirement System is 6.5 percent for the employee and 9.58 percent for the employer. In North Carolina, employees contribute six percent and the state contributes 10.51 percent. Georgia has recently moved to a mixed system for new employees that involves both a traditional defined benefit plan and a defined contribution (401(k)) plan. Employees contribute 1.25 percent of their salary to the defined benefit plan and receive benefits of 1.25 percent times the salary base per year of service at full retirement. Georgia state employees also have access to a defined contribution plan with a limited state match. Enrollment at one percent is automatic unless the employee opts out or opts in at a higher contribution rate. Teachers have a separate retirement system, with a 5.53 percent employee contribution and a 10.28 percent employer contribution.

Finally, the application of a cost of living adjustment (COLA) to retirement benefits is somewhat controversial for two reasons. First, some economists would argue that the consumer price index overstates the increase in the cost of living because households change their consumption mix in response to changing relative prices. Second, in a number of years retirees received cost of living adjustments when active employees did not, creating resentment and perceptions of inequitable treatment. This practice also burdened the retirement system with additional expense when there was no corresponding increase in employee contributions because salaries had not increased. The COLA is not a contractual but a discretionary provision in the South Carolina Retirement System and can therefore be changed at will.

The Retirement System and the General Fund

The treatment of retirement income affects the South Carolina General Fund primarily through the individual income tax. Pension income receives exceptionally generous treatment in the state income tax, which exempts all Social Security income and pension income up to $15,000 per recipient over the age of 65. So the decision to retire may be influenced by favorable income tax treatment, but it also represents less General Fund revenue. South Carolina has one of the most retiree-friendly income taxes of any of the 41 states that levy a general individual income tax.

Another potentially significant revenue loss to the General Fund comes from the TERI (Teacher and Employee Retention Incentive) program. TERIed state workers do pay regular individual income taxes on their continued salary while their pension fund is set aside in a non-interest-bearing account. After the end of the TERI period, retirees receive a regular pension, part of which is taxable, but the TERI funds generate no state income tax revenue unless the retiree chooses to make withdrawals. The pension income accrued during the TERI period is more like a state contribution to a 401(k) fund, for which taxes are only due upon withdrawal. If the funds are left on deposit—or more likely rolled over to an income-generating 401(k) fund—and eventually pass to heirs, without a state inheritance tax they may never be subject to either inheritance or income taxes.

Conclusion

South Carolina is one of many states re-examining its defined benefit state retirement system to strengthen its financial stability while ensuring that it is an important element of employee deferred compensation. Drawing on the experience of other states, there are a number of options to strengthen the system financially while ensuring continued benefits to current retirees and those approaching retirement. These present and future retirees need to be assured that their benefits will be secure. At the same time, in order to ensure the stability and security of the system, responsibility should be shared among the present and future retirees, active employees and the state as the employer and guarantor of the system.