When Do State and Local Pension Plans Encourage Workers to Retire?

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As more baby boomers reach their 60s and late 50s, many state and local governments risk a mass exodus of retirees, making it more difficult to provide public services. The nation's workforce will continue to age as life expectancy rises and the size of the younger labor pool stagnates; employers striving to meet their staffing needs will need to retain these older workers. Yet the traditional pension plans that cover most state and local government employees generally encourage early retirement. Well-designed public pension reforms could eliminate these work disincentives.

This brief describes how final average salary defined benefit pensions discourage work at older ages and reports the age at which employees maximize expected lifetime benefits from these traditional plans. Employees face an effective pay cut if they remain on the payroll past that age. Results are based on the Urban Institute's State and Local Employee Pension Plan database, which provides detailed benefit rules for state-administered retirement plans covering teachers, police officers and firefighters, and general state and local government employees in all 50 states and the District of Columbia. Page 2 details our methods.

How Do Traditional Plans Discourage Work at Older Ages?

Retirement benefits are an important part of the compensation received by public-sector workers. Seven in eight full-time state and local employees are covered by traditional pension plans that provide lifetime retirement benefits (Bureau of Labor Statistics 2013). Although details vary widely across jurisdictions, benefits are typically computed as a specified percentage of final salary multiplied by completed service years. Benefits begin when employees leave the payroll and meet the benefit eligibility criteria, usually some combination of age and years of service.

Many plans discourage work by retirement-eligible employees, who forfeit a month's worth of benefits for every month they remain on the job beyond the retirement age. Lifetime benefits often fall when older workers remain on the job past this point, because benefits lost while working exceed the benefits gained from an additional service month. Compounding these losses, some plans cap retirement benefits, so some long-tenured employees can't boost even their monthly benefits by working longer.[1] And most plans require employee contributions, so those who work longer must contribute more.

When Do Lifetime Benefits Begin Falling?

In 63 percent of traditional state and local pension plans, employees hired at age 25 maximize their lifetime benefits, net of their own contributions, by age 57. Net lifetime benefits fall when employees in these plans work longer, effectively cutting their annual compensation. Traditional plans covering police officers and firefighters generally begin penalizing work at even younger ages: 72 percent of age-25 hires max out by age 55. By contrast, only 16 percent of plans covering teachers reach their maximum by age 55. Nonetheless, teachers can boost their benefits by working past age 61 in only 25 percent of plans and by working past 64 in only 14 percent of plans (table 1).

Table 1. Ages at Which Employees Hired at Age 25 Maximize Their Lifetime Pension Benefits in Traditional State and Local Plans, by Occupation (%)

	All	Teachers	Police and fire	General state	General local
50 or younger	6	0	15	1	2
51–55	33	16	57	20	21
56–57	24	37	15	23	28
58–59	7	8	1	9	14
60–61	8	16	3	9	6
62–64	17	11	10	30	21
65 or older	6	14	0	8	7

Source: Authors' calculations from the Urban Institute's State and Local Employee Pension Plan database.
Notes: The sample is restricted to 612 traditional public pension plans administered at the state level. Calculations assume an annual nominal interest rate of 5 percent and annual inflation rate of 3 percent. Columns do not always total 100 because of rounding.

Employees who keep working after they have maximized their pension benefits often suffer steep loses. On average, age-25 hires lose 48 percent of their maximum net lifetime benefits by working until age 67, Social Security's full retirement age for those born after 1959.

Conclusions

Traditional state and local pensions generally penalize work at older ages. In more than three-fifths of plans, employees hired at age 25 lose pension benefits if they work past age 57, creating strong retirement incentives. Plans that pushed workers into early retirement might have made sense decades ago when employers were eager to hire young baby boomers surging into the labor force, but they are hard to justify today as the population ages. Health gains and declines in physical work also enable more older people to work now than before.

Additionally, many older government employees appear eager to extend their careers. Government retirees often work at new jobs while collecting their pensions, and many public-sector employees participate in deferred retirement option programs when they are available. These programs allow employees to work past the normal retirement age without forfeiting any pension benefits. Their pensions are deposited into special accounts while employees are working, and they may withdraw the balance when they quit. However, these programs are expensive, because they allow more employees to maximize their pensions (Alva, Coe, and Webb 2010).

Instead of traditional pensions, policymakers should consider such alternative designs as cash balance plans, which provide many of the same protections but do not penalize older workers. Retirement benefits from cash balance plans depend on employee accounts to which both employees and employers contribute. Those balances continue growing, regardless of age, until employees begin collecting benefits. Such fundamental reforms would treat workers of all ages fairly and help state and local governments meet their staffing needs.

About Our Data and Methods

The State and Local Employee Pension Plan Database (SLEPP) compiles information on employee contribution rates, vesting requirements, benefit eligibility rules, benefit formulas, early-retirement reductions, cost-of-living adjustments, and actuarial assumptions for retirement plans covering state and local government employees. Because states frequently change their plans for new hires but exempt incumbent employees, plan rules often vary by hire date. The database collects information for each of these variants, often called plan tiers, so it represents plan rules for nearly all participants employed in 2014. SLEPP includes 660 plan tiers covering teachers, police officers and firefighters, and general state and local government employees in all 50 states and the District of Columbia. Only state-administered plans are included; plans administered by municipalities are excluded. See www.urban.org/retirement_policy/pensionsproject.cfm for more information.

For each service year, we compute the lifetime pension benefits that plan participants can expect to receive if they quit, net of their own plan contributions. Future pension benefits are discounted by the probability that separating employees might die before they can collect their payments and by the interest they forgo while waiting. Employees' plan contributions are augmented by what they could have earned if they had been invested instead of paid to the plan. We assume 5 percent annual nominal interest, 3 percent annual inflation, and average salary growth. The calculations also use unisex mortality tables from the Social Security Administration.

We restrict our analysis to plans that provide traditional pensions. Cash balance, defined contribution, and hybrid plans are excluded. We analyze at the plan-tier level, weighting all plan tiers equally.

Note

1. Consider, for example, a plan that offers a lifetime pension beginning at age 60 that pays annual benefits equal to 2 percent of final average salary (averaged over the last five years) times years of service and adjusts benefits each year after retirement to keep pace with inflation. In return employees contribute 7 percent of their salary. An employee who retirees at age 60 with 30 years of service and final average salary of $60,000 would collect $36,000 in the first year and total expected lifetime benefits worth $686,000 over her lifetime (when future payments are expressed in constant 2014 dollars and discounted 5 percent a year with 3 percent annual inflation). Net of her own contributions, her lifetime benefits are worth $488,000. If she works one more year and her salary increases 2 percent a year from ages 55 to 60, she receives annual pension benefits worth $37,943 at age 61. However, expected lifetime benefits net of her own contributions fall to $453,000.

References

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The Urban Institute is a nonprofit, nonpartisan policy research and educational organization that examines the social, economic, and governance problems facing the nation. The Public Pension Project is a joint effort by Urban's Program on Retirement Policy and State and Local Finance Initiative. It examines the cost and financing of retirement plans provided to government employees, assesses their impact on retirement security and employee recruitment and retention, and evaluates reform options. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders.

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