Do State and Local Pensions Lock In Mid-Career Employees?

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Like their private-sector counterparts, most state and local government employees receive a salary, a promise of future retirement payments, and other fringe benefits each year. The annual increment to their future retirement pension supplements their salary and often makes up a significant portion of total compensation. However, future benefits from traditional pensions, which cover about seven of eight full-time state and local government employees (US Bureau of Labor Statistics 2013), generally grow erratically over a career. Workers typically accumulate very few benefits at younger ages and then reap large gains once they can begin collecting their pension. That surge in pension benefits creates strong incentives for mid-career employees to remain on the payroll, even those who are ill-suited to the job and could be more productive elsewhere.

This brief reports the size of mid-career pension spikes in traditional plans and describes how they arise. 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. Pages 2 and 3 detail our methods.

Why Do Traditional Pensions Grow Erratically?

Traditional pensions pay lifetime benefits tied to salary and service years. Annual payments are typically specified as a percentage of final average salary—generally computed over the final three or five years—multiplied by years of service. Pensions may begin once employers meet their plan's eligibility rules—usually based on age and service years—and leave the payroll. While employed, plan participants must usually contribute a portion of their salary to help offset pension costs.

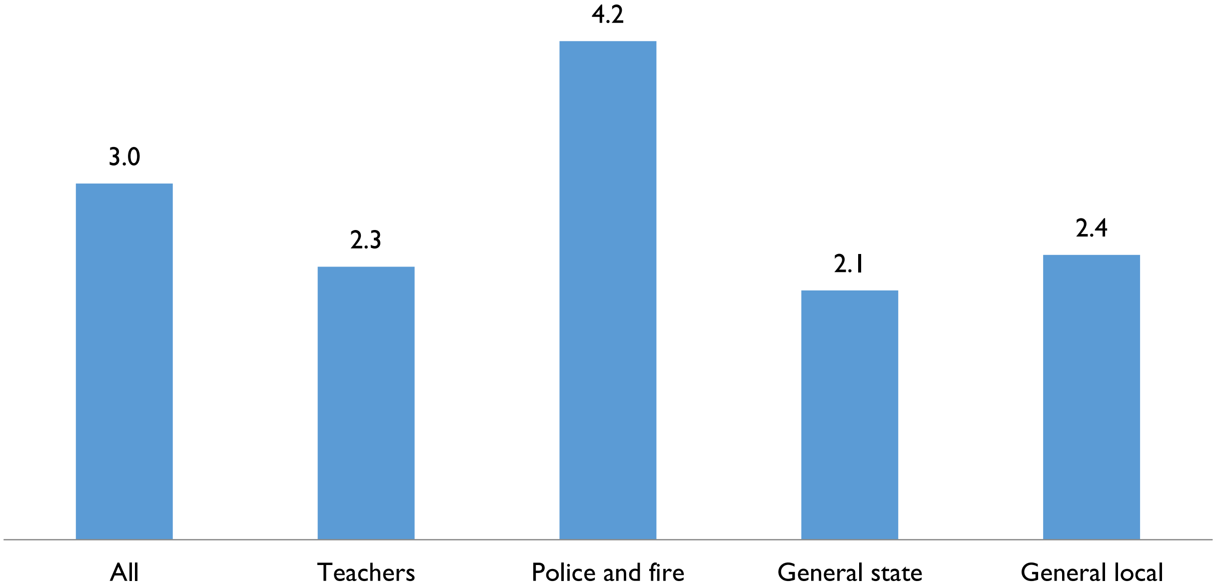
Few young employees accumulate future pension benefits worth more than—or even as much as—what they have contributed to their plan. Their future benefits are based on relatively low salaries they have received so far and the few service years they have already completed. Moreover, they must wait years to begin collecting. As a result, most employees who quit at young ages would do better by forgoing their future pension and collecting a refund on their contributions. Future pension benefits rise gradually as younger employers work longer and earn higher salaries, and benefits typically soar when employees first qualify for early retirement. Employees who work until early retirement eligibility don't have to wait to collect their pension as its value erodes with inflation and forgone interest. This benefit surge creates strong incentives for mid-career employees to remain with their employers.

How Much Do Pensions Spike in Mid-Career?

In traditional state and local plans, the career-maximum annual increment to employees' expected lifetime pension averages three times annual salary, an enormous gain that employees earn on top of their salary and any other fringe benefits the employer provides (figure 1). On average, that one-year benefit surge accounts for nearly half of the expected lifetime benefits that employees have accumulated to that point. Annual increments to lifetime pension benefits peak most often at age 55 for employees hired at age 25. In four-fifths of plans, the maximum increment falls between ages 45 and 58. Pension spikes are especially steep in police and fire plans, averaging more than four times annual salary.

In more than 10 percent of traditional plans (and more than 25 percent of police and fire plans) maximum annual increments to lifetime pensions exceed six times annual salary, and the maximum across all plans in our database approaches 11 times salary. The maximum annual spike in the expected value of lifetime benefits falls short of annual salary in only about one in four plans overall and only about one in eight plans covering police officers and firefighters.

Figure 1. Average Maximum Annual Increment to Lifetime Pension Benefits as Multiple of Salary, by Occupation



Source: Authors' calculations from the Urban Institute's State and Local Employee Pension Plan database.
Notes: Pension benefits are estimated for state and local government employees hired at age 25 and exclude the value of employee contributions. The sample is restricted to 612 traditonal 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.

Conclusions

State and local government employees typically earn much of their traditional pensions in a single year, creating strong incentives for mid-career workers to remain on the job until they realize these windfalls, usually in their fifties or late forties. These "golden handcuffs" might make sense if productivity surges in later careers or employee turnover is prohibitively expensive, perhaps because of high training costs. But there is no evidence that these conditions are more prevalent in the public sector than private sector, where traditional plans have faded away. And this compensation pattern has significant drawbacks. Mid-career pension spikes do not treat fairly those employees who leave their jobs early for reasons beyond their control, and they lock-in employees who may be ill-suited for their job. Pension reforms that allow benefits to grow more smoothly over a career would foster fairer compensation packages that better promote productivity.

About Our Methods and Data

The State and Local Employee Pension Plan (SLEPP) database 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 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 could have been earned if they had been invested instead of paid to the plan. We compute annual increments to lifetime pension benefits as the difference between expected lifetime benefits and what employees could have received if they had separated the previous year. The calculations 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 and hybrid plans are excluded. We carry out the analysis at the plan-tier level, weighting all plan tiers equally.

Reference

US Bureau of Labor Statistics. 2013. "National Compensation Survey: Employee Benefits in the United States, March 2013." Washington, DC: US Department of Labor. http://www.bls.gov/ncs/ebs/benefits/2013/ebbl0052.pdf.

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