



Five Ways to Improve the Distribution of Government Pension Benefits

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Efforts to reform the retirement plans provided to state and local government employees are gaining momentum across the country. Yet, the debate has focused almost exclusively on the financial problems of public pension plans, drowning out a broader discussion of how well these plans serve government employees, employers, and taxpayers. This brief highlights five promising reform options that could more fairly distribute retirement benefits across the public-sector workforce and help governments recruit and retain productive employees.

A fundamental shortcoming of most state and local retirement plans is that they fail to treat government workers fairly. How much employees benefit from their retirement plans varies sharply, often depending on how old they are when they join the plan and how long they remain in the plan, regardless of their productivity. Two workers employed in the same plan can receive very different pensions if one works a year longer than the other or if they join at different ages—even if they work the same number of years.

This pattern violates the basic principle of equal work for equal pay and limits public employers' ability to attract and retain qualified employees. For example, most public plans provide little retirement security to government employees who do not spend a full career in public service. As a result, these public-sector jobs may not appeal to the increasing number of younger workers who expect to switch jobs several times over their career. Many traditional final average salary (FAS) pension plans penalize work at older ages by reducing lifetime benefits for employees who remain on the job past the plan's retirement age, thus encouraging employees to retire even if they remain productive and want to keep working. These retirement incentives are increasingly problematic as the

population ages and the pool of younger workers stagnates. Additionally, most public plans lock in mid-career employees—who could be more productive elsewhere—by providing lucrative benefits if they remain on the job for a certain number of years but little if they separate a year or two earlier.

Promising Reform Options

Reform options that could more fairly distribute retirement benefits across the public-sector workforce include revising the benefit formula in an FAS plan, offering plans that deviate from the traditional FAS design, and extending Social Security coverage to all state and local government employees.

Revise the FAS Benefit Formula

States and localities can change the standard benefit formula in employee retirement plans to ensure that shorter-term employees hired at younger ages reap some rewards from the plan and that lifetime benefits do not fall when older employees continue working, thus distributing benefits more fairly across the workplace and eliminating early retirement incentives. Options include the following:

- *Reduce the vesting period.* Many FAS plans require employees to serve for 10 years—or even 20 years in many plans covering police officers and firefighters—before they qualify for pension benefits. Reducing vesting requirements would allow shorter-term employees to earn limited retirement benefits.
- *Credit employee contributions with the actual return earned on plan assets when providing refunds.* Most state and local plans require employee contributions and generally refund those contributions to separating employees who waive future retirement benefits or leave before they vest in the plan. However, most plans credit less interest to refunded contributions than what the plan actually earns on its investments, and some plans do not pay any interest on refunds. Crediting refunds with actual plan investment returns would prevent most shorter-term employees from losing money when they participate in the mandatory retirement plan; such returns provide employees with the same financial benefit as they would earn if they could instead invest their required plan contributions outside the plan.
- *Increase annual benefits for employees who separate before retiring.* Employees who separate before they may begin collecting their pensions generally receive small retirement benefits because their pensions earn no interest and erode with inflation while they are waiting to collect, and their benefits are based on the generally low earnings they received at younger ages. A better approach would be to index the starting benefit to changes in the consumer price index or, better yet, changes in average salaries from the year employees separate until they begin collecting. That feature would raise annual retirement benefits for employees who separate before reaching the retirement age.

- *Eliminate early retirement subsidies.* Many plans allow employees to collect reduced retirement benefits at early ages, but the benefit reductions are often too small to fully offset the additional payments early retirees receive. As a result, many plans reward early retirement. Additionally, these bonuses often lock in mid-career employees who reap substantial rewards by remaining in the plan until they qualify for early retirement. Ending early-retirement subsidies would eliminate incentives to retire early, better reward those employees who work longer, and help prevent mid-career employees from being locked into their jobs.
- *Boost the benefit multiplier for employees who work beyond the plan's retirement age.* Employees who work past the retirement age often receive fewer retirement benefits over their lifetime than their counterparts who retire earlier because their annual payments are not large enough to fully compensate them for the fewer payments they receive. The plan could better reward work at older ages by raising the benefit multiplier for employees who delay retirement. The increase should be tied to a retiree's age, as in Social Security's benefit formula, not years of service.
- *Provide COLAs that are tied to changes in the consumer price index.* To provide retirees with adequate financial security, plans must ensure that inflation does not erode the pension's value. Many—but not all—plans offer benefit escalators to retirees, but these adjustments are sometimes ad hoc. Other plans provide automatic escalators that are not tied to inflation. Increasing retirement benefits by the change in the consumer price index, as Social Security does, would protect retirees and restrict benefit raises to periods when retiree's financial security would otherwise be jeopardized.

Add a 401(k)-Type Plan

Moving to a 401(k) plan, either as a replacement to the traditional plan or a supplement to it, can help equalize retirement benefits among state and local government employees. All participants in 401(k) plans can receive the same employer contribution relative to their salaries, regardless of age or years of service, and their retirement accounts can continue to grow until they begin collecting benefits, even after they leave public employment. Transitioning to a 401(k)-type plan would also prevent governments from underfunding future pension obligations and shifting costs to future generations. By definition, 401(k) plans are fully funded, because employees own their account balances as soon as they vest.

Critics of 401(k) plans note that these plans have not worked well in the private sector, where they now dominate. Many employees offered such plans by their employers do not participate and few participants contribute enough to generate significant retirement income in old age. Additionally, relatively few 401(k) participants annuitize their balances, exposing them to the risk of depleting their retirement funds before they die. These potential shortcomings can be easily overcome in the public sector, however, by requiring employees to contribute to their retirement plans (which is already commonplace) and allowing members to collect their benefits as a lifelong annuity.

Move to a Cash Balance Plan

Another promising reform is to replace the traditional plan with a cash balance plan. These plans are already available to public-sector workers in some states, such as Kentucky, Nebraska, and Texas. As in a defined contribution plan, employees and employers contribute a certain percentage of salary to employee accounts each period. Benefits are expressed as individual account balances, but employee accounts are pooled and professionally managed. Depending on plan rules, the accounts earn fixed returns, market returns, or market returns that cannot fall below some minimum. Employees can typically either withdraw their account balances when they separate from government employment, or convert their balances into a lifetime annuity at or after the plan's retirement age.

Cash balance plans treat all employees fairly because employers can contribute the same share of an employee's salary to all employee retirement accounts, regardless of an employee's age or years of service. Employees who separate from public employment at relatively young ages fare better in a cash balance plan than an FAS plan because their cash balance accounts may continue to earn interest after they separate. By contrast, the FAS plan freezes benefits for employees who separate before they may begin collecting their pensions. Additionally, cash balance plan participants do not forfeit retirement benefits by remaining employed at older ages because they continue to receive employer contributions throughout their careers and their account balances can continue to rise.

Use Plan Contributions to Purchase Private-Sector Annuities

A more fundamental change to retirement plans provided to public-sector employees would involve using plan contributions from employers and employees to purchase annuities from private insurance companies. Senator Orrin Hatch has proposed such a plan.¹ Under his proposal, employees and employers would contribute a fixed percentage of employee's salary each year, as in a cash balance or 401(k) plan. But instead of depositing those funds into the public pension plan, employers would use them to purchase a deferred, fixed-income life annuity contract for each employee. These deferred annuities would continue to earn interest until employees retire, even after they have left public service, so employees who separate at young ages could benefit from the plan. Additionally, the plan would not penalize older workers by reducing their lifetime benefits, as in FAS plans. Another feature of this approach is that it prevents governments from underfunding retirement benefits, because insurance companies will not accept IOUs when issuing deferred annuities. Finally, because the plan issues deferred annuities throughout participants' careers, not all at once, participants do not face the risk that their annuity might be smaller than expected because it was issued when interest rates were unusually low.

Extend Social Security Coverage to all Government Employees

Nearly 30 percent of state and local government employees remain uncovered by Social Security. Extending Social Security coverage to all public-sector employees would improve their retirement income security. Social Security provides an inflation-protected lifetime annuity. It rewards work at older ages by increasing annual payments for beneficiaries who delay retirement. And it bases benefits

on lifetime earnings and rewards work at younger ages by indexing earnings to changes in the economy-wide average salary. As a result, earnings early in one's career—when salaries are lower—count just as much as earnings late in the career.

Conclusions

Recent public pension reforms have focused on cutting benefits and raising required employee contributions to close plan funding gaps. Although it is essential that governments fully fund employee retirement plans, this simple approach usually makes government employment less attractive to younger employees who expect to spend less than a full career in public service. These cuts require them to work even longer before qualifying for any employer-financed retirement benefits. More fundamental plan changes are necessary to distribute benefits more equally across the workforce and make government service attractive to both short-term and long-term employees,

Notes

1. SAFE Retirement Act of 2013. S. 1270 113th Congress.

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