Is a Cash Balance Plan the Right Choice for Louisiana State Employees?

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The public retirement system for state and local government employees in Louisiana is chronically underfunded, a problem that policymakers have been struggling to address for several years. In addition to strengthening commitments to fund the system, the state legislature attempted to change the benefit structure in several state-administered retirement plans. Under the proposed reform, the retirement plan administered by the Louisiana State Employees' Retirement System (LASERS) for general (nonhazardous duty) state employees would offer future members a cash balance retirement benefit instead of the final average salary (FAS) retirement benefit that is currently offered. This reform measure was signed into law in 2012 but overturned by the state supreme court because it did not pass the state legislature by a required supermajority of votes.

To explore the potential costs and benefits of pension reform for state workers, we simulated lifetime retirement benefits for newly hired employees under the existing plan, the cash balance plan passed by the state legislature in 2012, and an alternative reform package that we propose. The alternative reform would eliminate the existing FAS plan and replace it with a simpler and smaller cash balance plan than the one passed by the legislature. It would also extend Social Security coverage to state employees. We found that a slight majority of state employees who complete five years of service would do worse in the stand-alone cash balance plan than the existing FAS plan, but about three-fourths of employees would do better under our proposed alternative reforms than under the FAS plan.

Current and Alternative Plan Designs

LASERS currently provides a defined benefit retirement plan to state government employees based on their FAS, which is calculated as the average of the five highest consecutive years of salary. Members vest at five years of service, when they qualify for an annuity beginning at age 60 equal to 2.5 percent of FAS for each completed service year. Instead of waiting until they reach age 60, members may begin collecting their benefit as soon as they complete 20 years of service, although annual benefits for retirees who collect before age 60 are actuarially reduced to offset the additional payments they receive over their lifetime. The system does not automatically provide cost-of-living adjustments to retirees, although the state legislature has granted them in the past. Active plan members must contribute 8 percent of their salary to the plan each year. Members who leave the plan before completing the five-year vesting period receive the balance of their contributions without interest in lieu of any future benefits. Plan members are not covered by Social Security.

Under the cash balance plan passed by the state legislature in 2012, employers would contribute 4 percent of salary to a notional retirement account for each employee, and employees would contribute 8 percent of salary (as in the existing FAS plan). Both contributions would be credited to each employee's individual account, but the money would remain in the same asset pool as other system assets, which would continue to be professionally managed. All employee accounts would be credited with the same rate of return, based on the realized return on plan assets. The crediting rate would equal the rate of return minus one percentage point, but it could never fall below zero. The percentage point deduction is designed to compensate the plan for the cost of guaranteeing account balances against investment losses. We found, however, that the guarantee can be quite expensive under reasonable assumptions about expected investment returns and the volatility of those returns.

Because of the relatively high cost of the stand-alone cash balance plan, we propose an alternative reform that would contain the state's retirement costs, eliminate uncertainty surrounding those costs, and improve retirement income security for most state employees. This package would extend Social Security coverage to state employees and replace the existing FAS plan with a small and simple cash balance plan. Employees and the state would each pay the 6.2 percent Social Security payroll tax. Employees would also contribute 1.8 percent of their salary to the proposed cash balance plan, so that their total payroll deductions would equal 8 percent of salary, the same rate as in the FAS plan and the stand-alone cash balance plan. The state would not contribute to this small cash balance plan, and that plan would not include any investment guarantees. Instead, account balances would be credited with the actual return earned by plan assets.

How Much Would Retirees Receive under Each Plan?

To estimate how many state employees would likely fare better in the proposed stand-alone cash balance plan than the existing FAS plan and how many would fare better in the proposed alternative reform package that combines Social Security with a smaller cash balance plan, we compared lifetime pension benefits in each of the three plans for a simulated sample of newly hired employees. We assigned starting ages to new hires in our sample based on the distribution of actual starting ages provided by the plan actuaries. Employees in the simulations earn average salaries for their age and service year. Our simulations projected final service years by applying separation probabilities that varied by age and years of service as estimated by the plan actuaries. Outcomes under the cash balance plan are uncertain, depending on variable investment returns. We accounted for this uncertainty by simulating benefits under 10,000 investment return scenarios and computing the probability that lifetime benefits would be higher under the proposed reforms than in the existing FAS plan for each new hire. The random investment return for each scenario was drawn from a normal distribution with a mean of 8.0 percent and standard deviation of 11.3 percent. Additional details are available in our full report (Haaga, Johnson, and Southgate 2015).

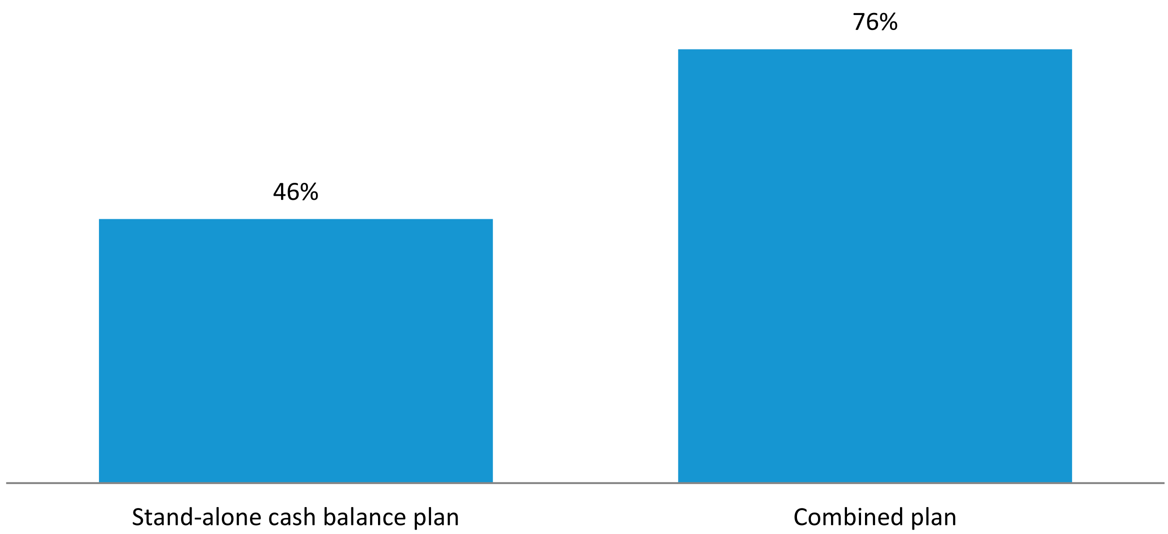
We found that new hires who remain in state employment for at least five years (and thus vest in the FAS plan) have only a 46 percent chance, overall, of doing better in the stand-alone cash balance plan than in the existing FAS plan (figure 1). Younger hires who complete less than 15 years of service or at least 40 years of service are especially likely to fare better under the stand-alone cash balance plan. The FAS plan provides only limited benefits to employees who separate before they begin collecting their pension, and FAS plan participants lose benefits if they work past the plan's retirement age. By contrast, participants who complete between 15 and 35 service years are more likely to fare better in the existing FAS plan.

The reform package that combines Social Security with a smaller cash balance plan should be more appealing to state employees than the stand-alone cash balance plan. We found that new hires who remain in state employment for at least five years have a 76 percent chance, overall, of doing better in that combined plan than in the existing FAS plan. Only employees hired before age 35 who complete between 15 and 34 years of service are more likely to receive more retirement income in the FAS plan than under the reform package. Employees hired later and those with less than 15 or more than 34 completed service years are much more likely to fare better under Social Security and the cash balance plan.

FIGURE 1

Share of New Hires Who Would Fare Better in Alternative Retirement Plans Than in the Existing FAS Plan

Simulated new hires employed by age 55 who complete at least five service years



Source: Haaga, Johnson, and Southgate, 2015.

Conclusions

Cash balance plans generally distribute retirement incomes more fairly across the workforce than FAS plans. They put all plan participants, not just long-term employees, on a path toward retirement security, and they do not penalize workers who remain on the job past the plan's retirement age. However, the investment guarantee that some cash balance plans provide can be quite costly if not well designed, which can lead employers to promise relatively limited benefits. Our simulations show that the overturned 2012 cash balance plan would not improve retirement insecurity for many state employees. Instead, most newly hired Louisiana state employees would receive more retirement income under a reform package that provides Social Security coverage and replaces the existing FAS plan with a relatively small cash balance plan that does not guarantee investment returns. Social Security coverage is valuable to state employees because it provides an inflation-indexed lifetime annuity, bases benefits on a measure of lifetime earnings indexed to changes in the economy-wide average salary, and raises starting payments for workers who wait to collect their benefits.

References

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Owen Haaga is a research associate in the Urban Institute's Income and Benefits Policy Center. His primary research interests center around state and local pension plans and long-term services and supports. He recently measured the impact of retirement plans on public employees' retention incentives in all 50 states and the District of Columbia as part of Urban's state and local pension plan report card. Haaga received a BA in economics from Vanderbilt University and an MA in economics from the University of Maryland.

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