



RESEARCH REPORT

The State of Public Pension Reform in Louisiana

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Introduction

The public retirement system for state and local workers 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 currently offered to employees. Under the cash balance plan, both the state and employees would contribute a certain percentage of each employee's salary to a retirement fund. Plan benefits would be expressed as an account balance, as in a 401(k) plan, but investments would be pooled and professionally managed. Each account would be credited with interest each year equal to the plan's actual return on assets minus one percentage point, but the annual return could never fall below zero.

Although Governor Bobby Jindal (R) signed legislation in 2012 creating a cash balance plan for new hires, the measure was controversial and ultimately overturned by the state supreme court. Opponents of the new cash balance plan argued that the change would expose plan participants to significant risk without necessarily saving the state any money (Morrissey 2012). In fact, an actuarial report commissioned by the legislature found that the cash balance plan would cost slightly more than the FAS plan it would replace. That projected cost increase doomed the reform effort, because the state constitution mandates that any changes to public sector pension benefits that raise actuarial costs must pass the state legislature by a supermajority of votes. The cash balance plan passed with only a simple majority and consequently was not implemented.

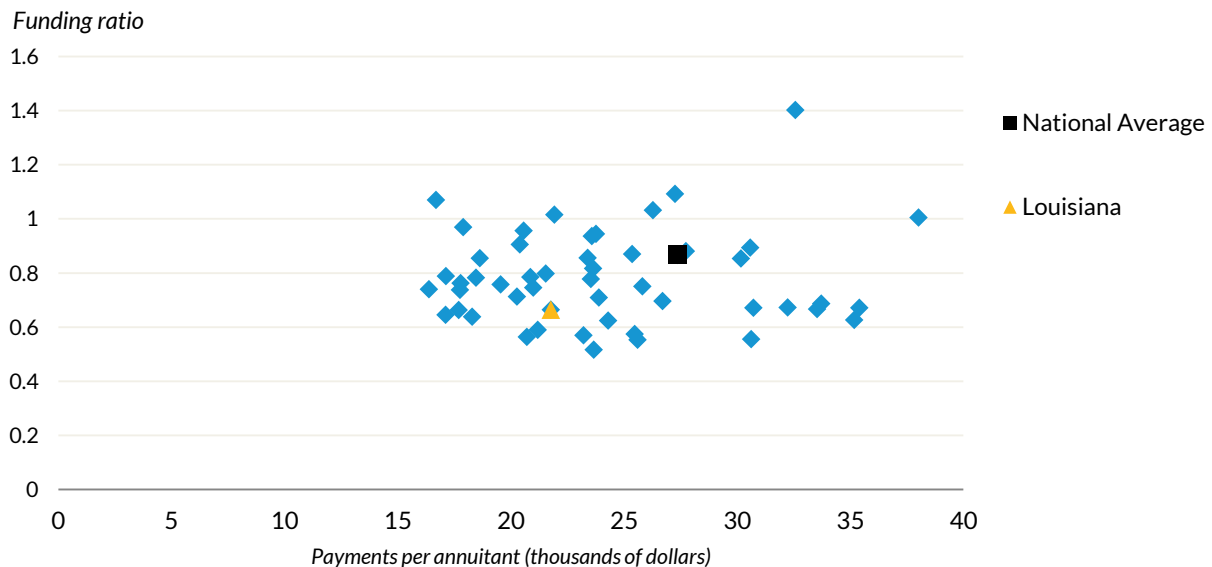
However, the court did not address more fundamental questions about the wisdom of reforming the state's pension plan. Would state employees generally fare better under the proposed cash balance plan than the existing FAS plan? Why would the cash balance plan cost more? Are there better alternatives than either plan? We addressed these issues by simulating lifetime retirement benefits for newly hired state employees under each plan and comparing expected outcomes. We found that 46 percent of newly hired employees who spend at least five years in state employment would fare better in the cash balance plan than in the existing FAS plan. However, 76 percent of these newly hired employees would fare better in an alternative reform package that replaces the FAS plan with a simple cash balance plan that lacks an investment guarantee and extends Social Security coverage to state employees.

Recent Pension Reform Efforts

Louisiana’s public employee retirement plans do not appear to work well for state and local government employees or taxpayers. Both employees and employers make substantial contributions to the public retirement system, yet employees do not receive much retirement security. Considering all state and local government employee pension plans in the state, we find that the Louisiana plans paid less than \$22,000 in retirement benefits per annuitant in 2012, significantly less than the national average of more than \$27,000 (figure 1). Despite the relatively low benefit level, the Louisiana plans held enough assets in 2012 to cover only 66 percent of estimated liabilities, compared with a national average of 87 percent. Only four states did worse than Louisiana on both measures. Even though the Louisiana plans do not appear to provide a very generous benefit to current retirees or a secure future retirement for current employees, both employees and employers are paying more, as a portion of current payroll, in Louisiana’s system than their counterparts in other states (figure 2). In 2012, employer contributions of 10.4 percent of payroll and employee contributions of 3.9 percent of payroll exceeded the national averages of 7.0 percent and 3.0 percent, respectively. Again, only four states do worse on both measures.

FIGURE 1
Payments per Annuitant and Funding Ratios by State in 2012

All state and local plans combined

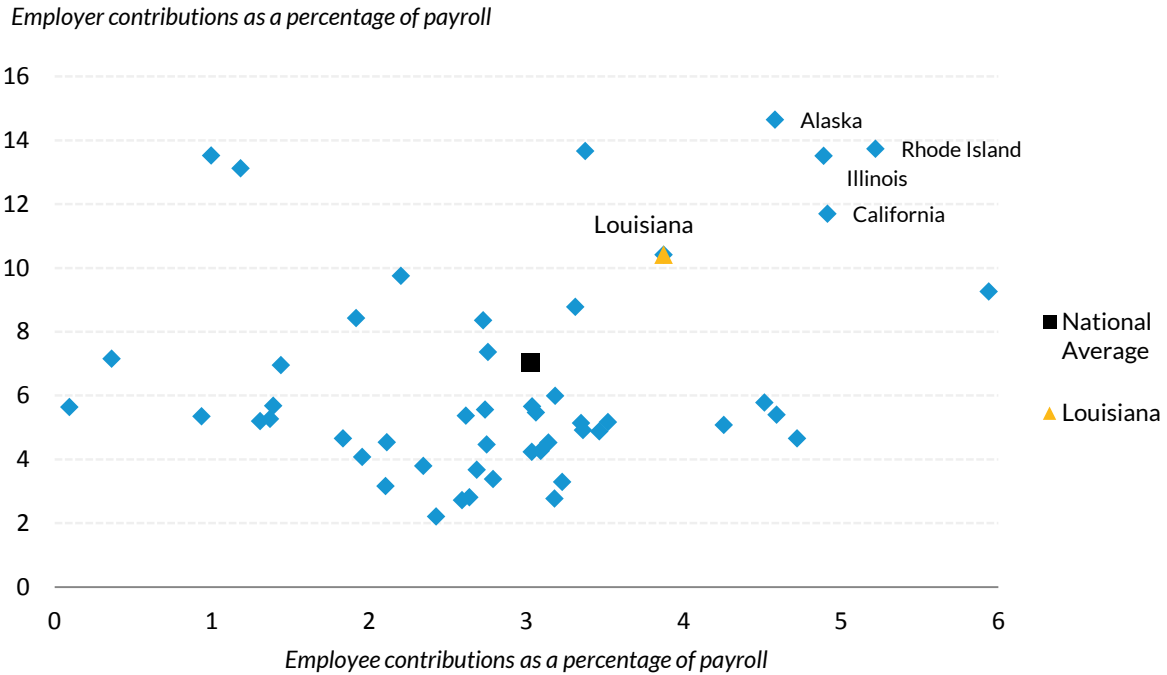


Source: US Census Bureau (2014) and authors’ calculations.

FIGURE 2

Employee and Employer Contributions to Public Retirement Plans by State in 2012

All state and local plans combined



Source: US Census Bureau (2014) and authors' calculations.

In light of these shortcomings, Louisiana has made several attempts recently to reform the state pension system and provide a better deal for taxpayers and employees. These reforms have included restrictions on benefit increases and cost-of-living adjustments for retirees, a constitutional provision mandating that the state eventually fully fund promised pension benefits, and a proposal to replace the LASERS FAS plan with a cash balance plan for new employees.

Under the existing system, LASERS 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.¹ The system does not automatically increase retirement benefits for changes in the cost of living, although the state legislature has granted cost-of-living adjustments in the past. Active plan members must contribute 8 percent of their salary to the plan per

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, 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 the 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 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.

Although legislation creating the cash balance plan passed the state legislature and was signed by Governor Jindal in 2012, the measure was overturned by the Louisiana Supreme Court in 2013 and is not currently in effect. The court invalidated the cash balance plan because it violated a recent amendment to the state constitution that requires any pension change with an "actuarial cost" to pass the legislature by a two-thirds supermajority of votes (*Retired State Employees Association v. State of Louisiana*). The cash balance plan passed by only a simple majority. An actuarial valuation performed for the legislature by the Office of the Legislative Auditor (2012) estimated that the new cash balance plan would cost more than the existing FAS plan. Another valuation by Buck Consultants (2012) found no actuarial cost associated with the new plan. However, the court ruled that the estimate from the Office of the Legislative Auditor was the authoritative valuation for the purposes of the constitutional provision in question and struck down the reform bill containing the new cash balance plan.

How Much Would Retirees Receive in the Two Plans?

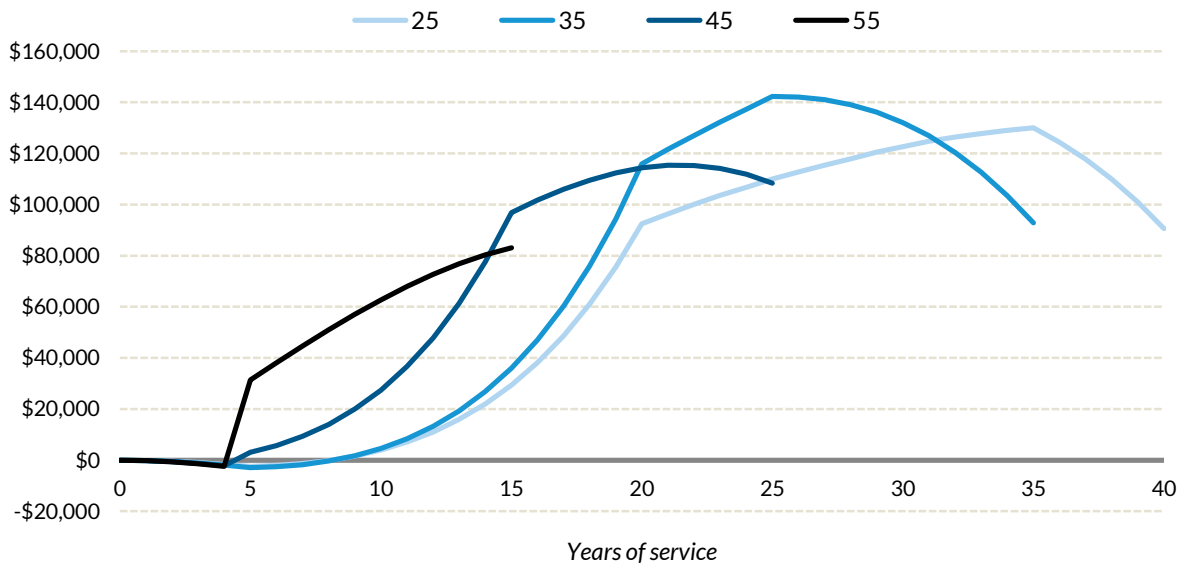
To better understand how much the proposed cash balance plan would cost and how it might affect future retirees, we simulated lifetime pension benefits for new hires in the existing FAS plan and the proposed cash balance plan. State employees were assumed to earn the average salaries for their ages and years of service among those hired in the fall of 2013, as projected by the plan actuaries (Louisiana State Employees' Retirement System 2013). Our simulations assumed plan participants discounted future benefits by 8 percent a year, the nominal interest rate adopted by the plan trustees. All financial amounts are expressed in constant 2014 dollars.

For the cash balance plan, the value of lifetime benefits is simply the accumulated account balance. For the FAS plan, we computed the value of lifetime benefits by summing all future annual payments, discounting them by 8 percent a year and by the probability that employees will die before they can collect. We computed annual pension payments by applying the benefit formula to our assumed salary histories. The calculations assumed that all plan participants receive their payments as single-life annuities—forgoing survivor benefits for any spouse—and that they begin collecting their pensions at the age that maximizes the lifetime value of their benefits. Mortality probabilities were derived from unisex life tables compiled by the US Social Security Administration. The simulated value of employees' lifetime plan contributions assumes that those contributions would earn 8 percent annual returns if invested outside the pension plan. This assumption corresponds to an inflation-adjusted annual return of 5 percent, which is similar to the average return since 1926 for a portfolio split evenly between stocks and bonds, after adjustments for investment fees.² When we estimated the value of lifetime benefits in the FAS plan, we further assumed that plan participants would elect to have their contributions refunded instead of receiving pensions if the refunds were worth more.

Figure 3 shows how the value of lifetime pension benefits, net of employee contributions, increases with years of service in the FAS plan for workers hired at various ages. For all starting ages, the net value of lifetime benefits is negative for employees who complete less than five years of service. They never receive a pension and simply get their plan contributions back without interest. They would have done better financially if they could have invested their plan contributions outside the plan and earned interest. Net lifetime benefits increase rapidly with additional service years, although the exact pattern varies with starting age. For employees hired at age 25, net benefits rise sharply until they complete 20 service years, when they qualify for early retirement benefits, and then rise more slowly until they

complete 35 service years, when they reach age 60. However, net lifetime benefits fall if age-25 hires work beyond age 60. Annual pension benefits increase with additional work, but the increment is not large enough to offset the benefit checks that workers lose by remaining on the job past the retirement age and the additional contributions they must make to the plan.

FIGURE 3
Value of Lifetime Benefits, Net of Employee Contributions
LASERS existing FAS plan by starting age



Source: Authors' calculations based on plan documents and actuarial reports.
Notes: All monetary amounts are in constant 2014 dollars. Future benefits are discounted at 8 percent and the annual inflation rate is assumed to be 3 percent, the rates adopted by the state retirement system.

Employees hired at older ages accumulate benefits more quickly than those hired at younger ages because they can collect their pensions sooner. After 20 years of service, for example, an age-35 hire has accumulated lifetime pension benefits worth \$114,000 net of employee contributions, compared with only \$92,000 for an age-25 hire. After 10 years of service, net lifetime benefits total \$4,000 for an age-25 hire, \$27,000 for an age-45 hire, and \$63,000 for an age-55 hire. Similarly, the value of net lifetime benefits begins falling sooner for older hires than younger hires. Net lifetime benefits peak at 21 service years for age-45 hires, 25 service years for age-35 hires, and 35 service years for age-25 hires.

An alternative to measuring the expected value of lifetime benefits net of employee contributions in dollars is to express the value as the portion of salary that the state would have to set aside each year

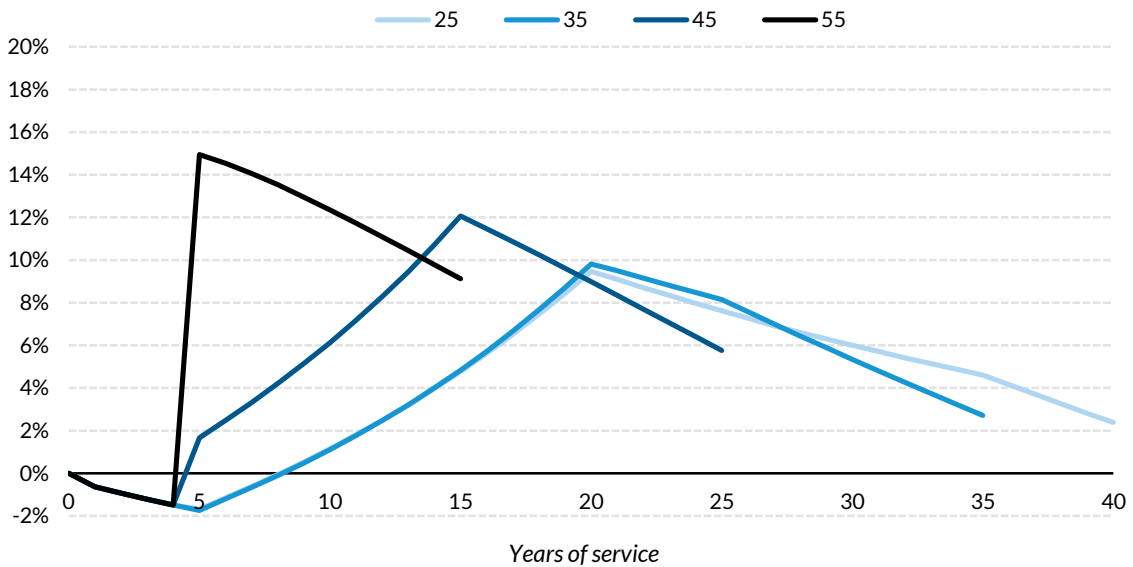
(with employee contributions) to finance the stream of future benefits that employees will receive once they retire. These calculations show how much retirement benefits supplement employee salaries, averaged over their careers, assuming that employee contributions earn 8 percent nominal returns, the rate assumed by the plan trustees.

How much the FAS plan supplements salaries varies sharply with starting age and final years of service. For age-25 hires who separate after five years of service, the plan reduces salaries by 1.7 percent each year they work because their future pension benefits are worth less than the value of their required plan contributions (figure 4). The plan boosts salaries for age-25 hires who remain employed for at least 9 years, with the bonus rising to 9.0 percent each year for those who separate after completing 20 years of service. The supplement steadily declines for age-25 hires who remain on the job for more than 20 years, falling to 6.0 percent at 30 years and 2.4 percent at 40 years of service. For age 45-hires, the salary supplement from the FAS plan ranges from a low of -1.4 percent for those who separate after 4 years of service to a high of 11.5 percent for those who separate after 16 years. The annual salary supplement peaks at 14.9 percent for age-55 hires separating after completing five years of service. This disparity in what employees get from the FAS plan violates the principle of equal pay for equal work. A fairer plan would supplement salaries by about the same percentage regardless of hire age or completed years of service.

By design, the expected value of net lifetime benefits increases much more smoothly in the cash balance plan than the FAS plan. In the cash balance plan, net lifetime benefits equal the employee's account balance minus the value of the employee's required plan contributions. Each year, the total expected account balance grows by contributions equal to 12 percent of salary (4 percent from employers and 8 percent from employees) and investment returns equal to 7 percent of the previous year's balance (expected 8 percent return on plan assets minus 1 percent). The value of the employee's required plan contributions increases each year by 8 percent of salary plus expected returns of 8 percent of the previous year's accumulated contributions—the return we assume employees could earn if they invested their contributions outside the plan. The total account balance net of the value of employees' contributions grows steadily throughout an employee's career (figure 5). Account balances are higher for workers hired at older ages because they earn higher salaries at a given year of service than workers hired at younger ages.

FIGURE 4

Career-Average Employer Cost as Percentage of Salary LASERS Existing FAS Plan by Starting Age

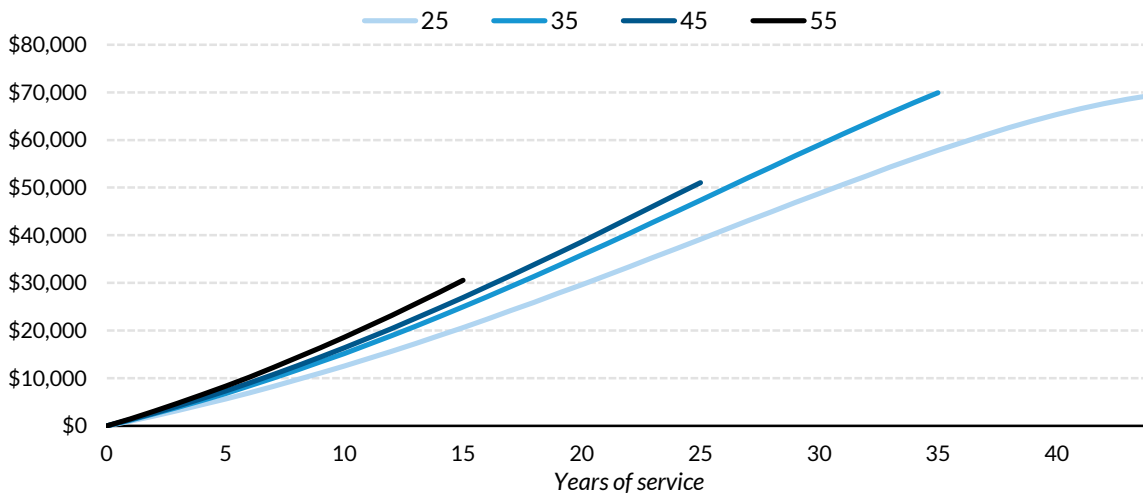


Source: Authors' calculations based on plan documents and actuarial reports.

Notes: All monetary amounts are in constant 2014 dollars. The figure reports the fixed percentage of employees' salaries employers would have to contribute each year to finance promised benefits. Future benefits are discounted at 8 percent and the annual inflation rate is assumed to be 3 percent, the rates adopted by the state retirement system.

FIGURE 5

Value of Lifetime Benefits, Net of Employee Contributions LASERS Proposed Cash Balance Plan by Starting Age



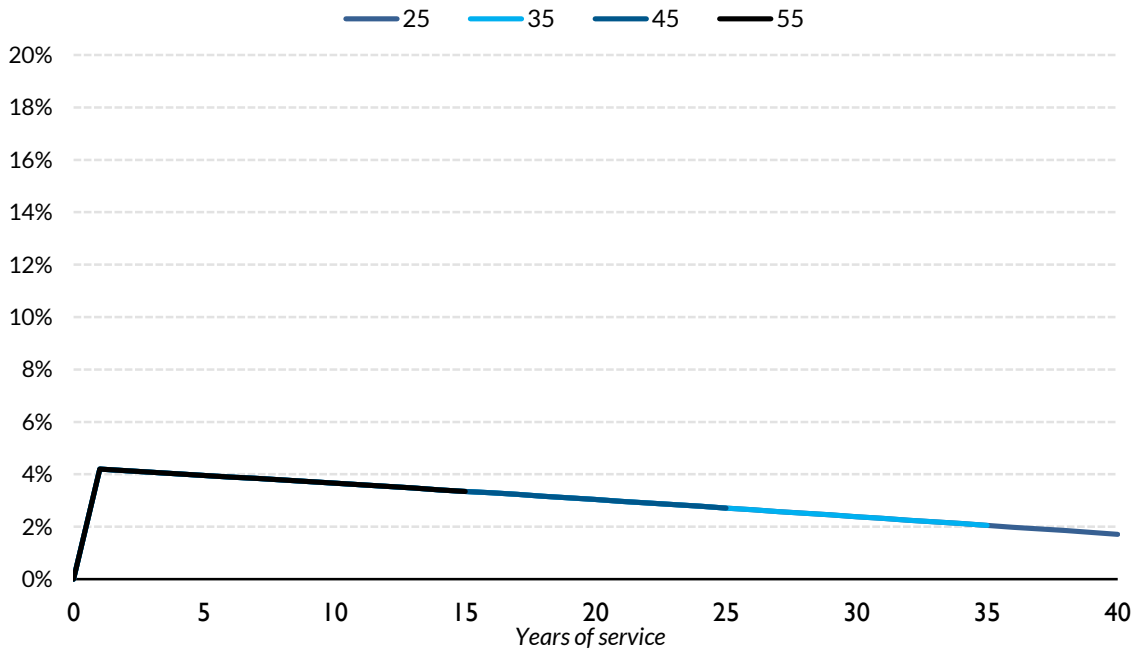
Source: Authors' calculations based on plan documents and actuarial reports.

Notes: All monetary amounts are in constant 2014 dollars. Future benefits are discounted at 8 percent and the annual inflation rate is assumed to be 3 percent, the rates adopted by the state retirement system.

Because the value of employee contributions increases over time, the amount by which the cash balance plan supplements salaries declines with years of service. Each year, the cash balance plan supplements salaries by the employer’s contribution minus the cost of the employee contribution. The expected cost of the employee contribution is the difference between what those contributions earn inside the plan (7 percent) and what they could earn outside the plan (8 percent). The gap between those two rates become more significant as the account balance grows over time, causing the salary supplement to fall as years of completed service rise. The cash balance supplements salaries 4 percent each year for employees who separate after 5 years, 3 percent each year for employees who separate after 20 years, and 2 percent each year for employees who separate after 35 years (figure 6).

FIGURE 6

Career-Average Employer Cost as Percentage of Salary LASERS Proposed Cash Balance Plan by Starting Age



Source: Authors’ calculations based on plan documents and actuarial reports.

Notes: All monetary amounts are in constant 2014 dollars. The figure reports the fixed percentage of employees’ salaries that employers would have to contribute each year to finance promised benefits. Future benefits are discounted at 8 percent and the annual inflation rate is assumed to be 3 percent, the rates adopted by the public employee retirement system.

To estimate how many state employees would likely fare better in the proposed cash balance plan than the existing FAS plan, we compared lifetime pension benefits in each plan 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 in the cash balance plan than 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.

We found that newly hired state employees are slightly more likely to fare better in the existing FAS plan than the proposed cash balance plan. Overall, there is a 46 percent chance that lifetime benefits net of employee contributions will be higher in the cash balance plan (table 1). Younger hires who complete less than 15 service years or at least 40 service years are especially likely to fare better under the cash balance plan, whereas older hires and most employees who complete between 15 and 35 service years are more likely to fare better in the existing FAS plan. State employees hired between ages 25 and 29, for example, have an 85 percent chance of accumulating more benefits in the cash balance plan if they separate after 10 to 14 years of service, but only an 18 percent chance of faring better in the cash balance plan if they separate after 20 to 24 years. Employees hired between ages 45 and 49 who separate after 10 to 14 years of service have only a 3 percent change of accumulating more benefits in the cash balance plan.

TABLE 1

Share of Vested Participants Expected to Fare Better in the Proposed Cash Balance Plan than the Existing FAS Plan

By starting age and final years of service

Service years	Starting Age							All
	18-24	25-29	30-34	35-39	40-44	45-49	50-54	
5-9	100%	100%	100%	100%	97%	45%	1%	77%
10-14	84%	85%	85%	84%	53%	3%	1%	48%
15-19	30%	30%	28%	23%	9%	5%	9%	19%
20-24	17%	18%	18%	13%	17%	24%	37%	17%
25-29	37%	31%	28%	33%	43%	55%	.	32%
30-34	48%	48%	53%	62%	74%	.	.	51%
35-39	65%	68%	78%	85%	.	.	.	70%
40-44	84%	88%	94%	.	.	.	.	87%
45-49	97%	99%	.	.	.	.	.	98%
50-54	100%	.	.	.	.	.	.	100%
All	62%	60%	57%	52%	43%	17%	2%	46%

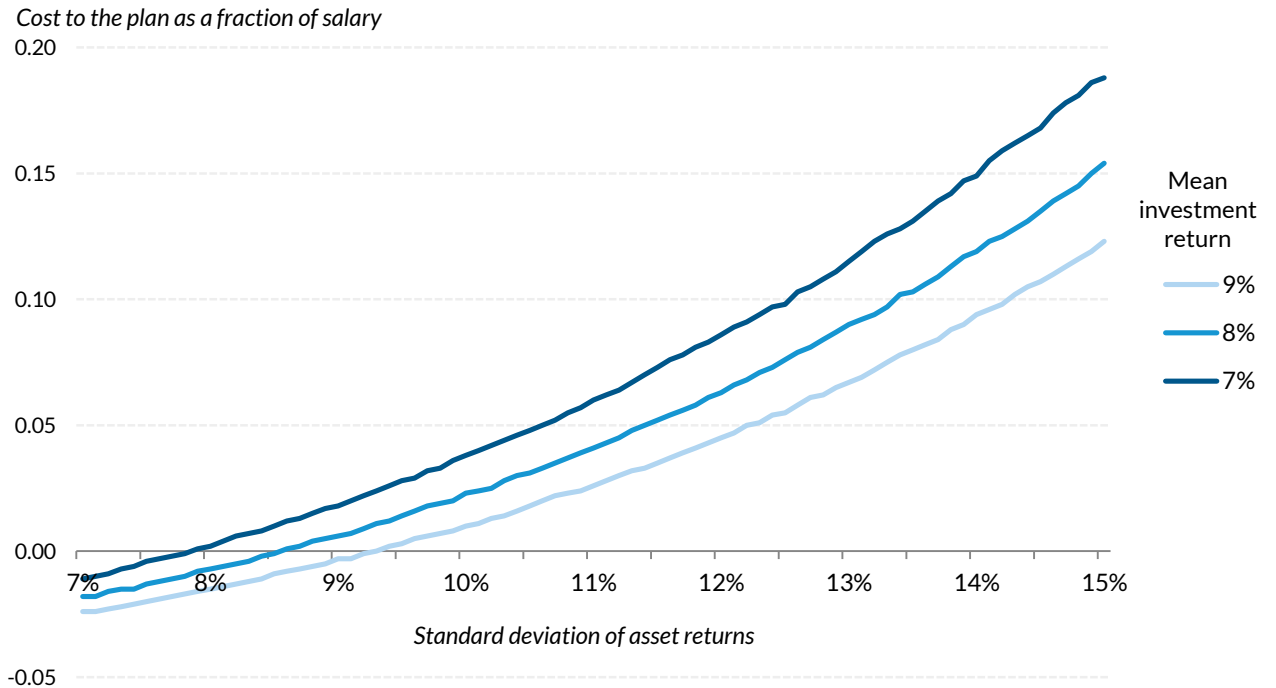
Source: Authors' calculations based on plan documents and actuarial reports.

Notes: All monetary amounts are in constant 2014 dollars. Future benefits are discounted at 8 percent and the annual inflation rate is assumed to be 3 percent, the rates adopted by the state retirement system.

The cash balance plan costs more than the existing FAS plan, at least according to the state's valuation, even though it would provide fewer lifetime retirement benefits to a small majority of new hires because of the high expense of guaranteeing that participants' annual investment returns are never negative. To measure this expense, we conducted a Monte Carlo simulation of the cost to the plan of providing the cash balance crediting rate to 12 percent of a new hire's salary for the next 40 years. Figure 7 shows the results as a fraction of a worker's salary. If the expected return is 8 percent and the standard deviation is 11 percent, this insurance costs 4 percent of salary, the same amount the state contributes to each retirement account. Insurance costs increase if expected returns fall or if returns become more volatile (and the standard deviation rises). For example, the insurance cost increases to 6 percent of salary if the expected return falls to 7 percent (and the standard deviation remains at 11 percent), and it increases to 9 percent of salary if the standard deviation rises to 13 percent (and the expected return remains at 8 percent). The plan could generate a small profit (or exhibit negative costs), but only if expected returns are unreasonably high or if returns are unusually stable.

FIGURE 7

Cost of Insuring Contributions Against Loss over 40 Years LASERS Proposed Cash Balance Plan under Selected Mean Asset Return Assumptions



Source: Authors' calculations.

Note: Simulation parameters are shown as fractions, and cost is shown as a fraction of current salary.

Allowing employees to participate in the upside of investment returns is a worthwhile goal, but insuring them against losses can generate large and unpredictable costs for the state. Our simulations make the unrealistic assumption that the state is risk neutral; incorporating risk aversion into our simulations would further boost insurance costs. Moreover, any losses incurred from the cash balance crediting scheme would be almost perfectly correlated with losses experienced by the state retirement system's existing pool of assets, which is already troubled. These drawbacks make the system a poor candidate for insuring the investment risk that the cash balance plan would introduce into employees' retirement wealth.

Adding Social Security to the State's Benefit Package

A better way to improve state employees' retirement security, allow them to reap some rewards when equity markets perform well, protect them from unnecessary risk, and control plan costs would be to replace the existing FAS plan with a simple cash balance plan that lacks an investment guarantee and extend Social Security coverage to state employees, who currently lack this coverage.

Under our proposed reform package, employees and the state would each pay the 6.2 percent Social Security payroll tax. The state would not contribute to the new cash balance plan. As result, the reform package would likely be less costly to the state than the 2012 cash balance plan—even though the state would only contribute 4 percent of employees' salary to that plan—because the investment guarantee risk that the state assumed in the 2012 cash balance plan likely costs more than 2.2 percent of payroll. Our proposed reform package would also require employees to 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 2012 cash balance plan. The new cash balance plan would not include any investment guarantees. Instead, employees would now receive a significant defined benefit annuity as a backstop to the performance of their cash balance account. Account balances would be credited with the actual return earned by plan assets. This combination would provide something like a defined contribution for the state and a defined benefit for employees, plus some upside exposure for employees that is almost costless (except for some administrative expenses) for the state employer to provide.

When we simulated retirement benefits under this reform package, 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 this combined plan than in the existing FAS plan (table 2). 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.

TABLE 2

Share of Vested Participants Expected to Fare Better in the Combined Plan Than the Existing FAS Plan By starting age and final years of service

Years of service	Starting Age							All
	18-24	25-29	30-34	35-39	40-44	45-49	50-54	
5-9	100%	100%	100%	100%	100%	100%	100%	100%
10-14	56%	80%	98%	100%	100%	100%	100%	91%
15-19	6%	15%	50%	94%	100%	100%	97%	69%
20-24	2%	7%	29%	86%	100%	94%	74%	47%
25-29	14%	20%	61%	98%	92%	73%	.	36%
30-34	26%	46%	88%	85%	73%	.	.	46%
35-39	64%	76%	72%	70%	.	.	.	71%
40-44	84%	71%	67%	.	.	.	.	75%
45-49	84%	78%	.	.	.	.	.	80%
50-54	88%	.	.	.	.	.	.	88%
All	47%	54%	69%	94%	100%	99%	99%	76%

Source: Authors' calculations based on plan documents and actuarial reports.

Notes: All monetary amounts are in constant 2014 dollars. Future benefits are discounted at 8 percent and the annual inflation rate is assumed to be 3 percent, the rates adopted by the state retirement system.

Conclusions

Like most FAS pension plans, the existing FAS plan for Louisiana state government employees does not distribute benefits fairly across the workforce. How much participants get out of the plan varies widely depending on when they join and how long they work. Younger hires who spend many years in the plan and older hires generally accrue substantial benefits in the FAS plan. However, younger hires forfeit lifetime pension benefits if they work past the retirement age, creating strong retirement incentives. Such incentives are increasingly problematic as the population ages and the pool of younger workers stagnates. In addition, the state FAS plan provides few or no benefits to younger hires who leave state employment before they may start collecting their pension. This plan feature may hinder recruitment efforts, as many younger workers now expect to move from one employer to another several times over their careers.

Cash balance plans, including the 2012 plan that would have been offered to Louisiana state employees had it not been invalidated by the state supreme court, generally distribute benefits more fairly 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. Our simulations show that the proposed 2012 cash balance plan would not improve retirement incomes for many state employees because plan benefits would be limited to control the cost of the investment guarantee.

A better reform approach would replace the FAS plan with a smaller cash balance plan that does not guarantee investment returns and extend Social Security coverage to state employees. 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. This reform package would cost less than the existing FAS plan and the 2012 cash balance plan. Our simulations indicate that 76 percent of newly hired state employees who remain in state employment for at least five years would receive more retirement benefits under this reform package than under the existing state FAS plan.

Notes

1. For modeling purposes, we assumed that these reductions follow the rules specified for the partial cash-out provision detailed in plan documents.
2. Between 1926 and 2013, the average annual compound growth rate for a portfolio evenly split between stocks and bonds was 5.38 percent (Morningstar 2014).

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About the Authors

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.

Richard W. Johnson is a senior fellow in the Income and Benefits Policy Center at the Urban Institute, where he directs the Program on Retirement Policy. His current research focuses on older Americans' employment and retirement decisions, long-term services and supports for older adults with disabilities, and state and local pensions. Recent studies have examined job loss at older ages, occupational change after age 50, employment prospects for 50+ African Americans and Hispanics, and the impact of the 2007–09 recession and its aftermath on older workers and future retirement incomes. He has also written extensively about retirement preparedness, including the financial and health risks people face as they approach retirement, economic hardship in the years before Social Security's early eligibility age, and the adequacy of the disability safety net.

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