

Regarding recent pension trends, keep in mind that:

- Public pensions have faced financial challenges in recent years, but have already implemented significant reforms that should fully offset the effects of the economic downturn.
- A small number of states have made more drastic changes, moving to alternative retirement plan designs such as “hybrid” DB/DC plans or cash balance plans.
- Defined benefit (DB) pension plans are still the most economically efficient way to fund retirement.
- Public pension plans can provide a vehicle to expand retirement plan coverage to private sector workers.
- Pension designs from Australia, Canada, and the Netherlands can also offer models to improve the U.S. retirement system.

In the aftermath of the financial crisis, retirement security in the United States has been under new scrutiny. Public sector pension plans have faced some challenges, as the economic downturn caused their funding levels to drop while state budgets were squeezed. Meanwhile, more attention is being given to the broader challenge of retirement security, as more and more Boomers approach retirement age with little set aside to fund their retirement years.

You may have wondered: what are the recent trends in public pension plans? What are the trends for broader retirement security, and can public sector pensions offer a solution to improve the retirement prospects for private sector workers? Can international pensions provide a model for an improved system within the U.S.?



## PUBLIC PENSION CHANGES: MOST STATES STAY WITH DB, BUT SOME HAVE MOVED TO ALTERNATIVE DESIGNS

Like all investors, public pension funds took a big financial loss in the 2008-2009 market downturn. Since that time, as the stock market has rebounded, so has the value of public pension funds. But those gains have not fully made up for the huge prior losses.<sup>1</sup>

At the same time, the economic crisis also negatively impacted state budgets across the country. In fiscal year 2013, states faced a cumulative budget gap of \$55 billion, which they have managed to close.<sup>2</sup> States have implemented various changes in order to balance their budgets, including furloughs and layoffs for state employees, as well as changes to pension plans.<sup>3</sup>

The pension reforms enacted have been quite substantive and varied, including increasing employer or employee contributions and/or changing the benefit design.<sup>4</sup> These reforms are financially significant. Forecasts from Boston College show that in most cases, the reforms already implemented will, over time, fully fill the funding gaps caused by the financial crisis.<sup>5</sup>

Thus, across the nation, most states and localities remain committed to traditional pensions, with a view to long-term solvency. However, there are some exceptions to this rule, with a handful of states implementing hybrid or cash balance designs.

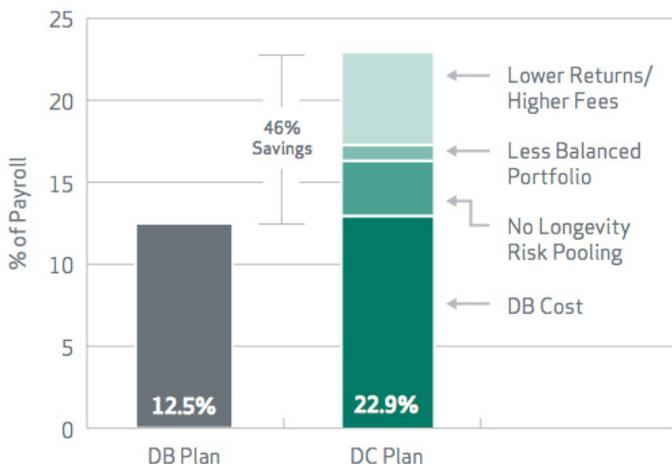
For instance, Michigan School Employees, Rhode Island, Tennessee, and Virginia recently adopted “hybrid” pension plans. A hybrid design includes both a DB and a DC component. In general, the DB portion of a hybrid is far less generous than the previous DB plan, and the DC component is meant to somewhat offset this lower benefit. In Michigan, the hybrid is for new employees hired after July 2010.<sup>6</sup> Rhode Island moved all employees, except judges and public safety employees, into the hybrid plan in 2012. The Tennessee and Virginia hybrid plans will only be for new members hired as of January 2014.<sup>7</sup>

In Utah, employees hired after January 2011 have an option of either a hybrid plan (with a DB and DC component), or only a DC plan. Employers will contribute no more than 10% of salary for the DB pension of the hybrid plan, and employees will have to make up the difference if this contribution is insufficient to fully fund the benefits. If the DB pension is overfunded, the excess will be deposited into employees’ DC accounts. Alternatively, for those employees who choose the DC-only plan, employers will contribute 10% of salary to the employees’ DC account.<sup>8</sup>

Kansas and Kentucky have adopted cash balance designs. In a cash balance plan, each employee accrues a pay credit that is deposited by the employer into a “notional account” each year. In addition, a specified annual interest credit accrues on the account balance. A cash balance plan acts like a DB plan in that investments are pooled and collectively managed, the benefit amount is guaranteed in retirement, and there is a lifetime income option. A cash balance “looks” like a DC plan, however, in that an employee notional account grows each year with salary credits and interest credits. The cash balance plans in Kansas and Kentucky are only for newly hired members—in Kansas, those hired as of January 2015, and in Kentucky, as of January 2014.<sup>9</sup>

It is important to note that the move to alternative retirement systems does not save money on retirement plan costs. Traditional pension plans remain the most cost-effective way to fund a retirement program, due to their pooled nature and the associated economies of scale.<sup>10</sup> Those states that purport to “save money” by switching are doing so by decreasing the value of the retirement benefit—which ultimately will hurt the retirement security of their public workers.

### Cost of DB and DC Plan as % of Payroll



For example, employer costs under Michigan’s hybrid plan are expected to decline, but only because the hybrid plan offers a less generous benefit than the DB pension.<sup>11</sup> In Rhode Island, research shows that the hybrid switch will likely cost taxpayers more money—even as workers’ benefits are reduced by as much as 14%.<sup>12</sup>

## PUBLIC PENSION PLANS CAN HELP TO IMPROVE PRIVATE-SECTOR RETIREMENT SECURITY

Meanwhile, a national retirement security crisis looms. Half of all workers have no workplace retirement plan at all. For decades, the number of private pension plans has been in decline, likely replaced by 401(k) plans that have succeeded in transferring a variety of risks onto individual employees. The prospects are daunting. Boston College estimates there is currently a deficit of \$6.6 trillion between what workers would need today to sufficiently fund their retirement and what they actually have.<sup>13</sup>

As a result, policymakers at the local and national levels have been looking to various solutions to bolster the retirement security for private sector workers. Proposals to improve Americans’ retirement prospects have run the gamut, including strengthening existing pensions and encouraging new ones, retooling defined contribution plans, and even implementing entirely new retirement programs.<sup>14</sup>

One potential solution involves opening up public sector pension plans to private workers. The idea is that the public pension system provides a retirement infrastructure that is cost-efficient, with low administrative costs and high quality investments. For those private sector workers with no retirement plan at all, the ability to access and invest in such a system could go a long way in helping them finance their retirement. For small employers, the ability to provide a retirement solution for their employees with minimal legal and administrative burdens could be appealing.

In 2012, California passed legislation to study and create the “California Secure Choice Retirement Savings Program.” Sponsors of the law are hoping that it will strengthen the retirement security of the 6.3 million Californians who have no workplace retirement plan at all.<sup>15</sup>

Under the program, Californians whose employers don’t offer retirement plans will be enrolled automatically in a low-cost, low-risk retirement account. Those who don’t want to participate in the program can opt out at any time. The default contribution is 3 percent, which workers can increase or decrease. Employers have very minimal responsibility—their only obligation is to handle the administration of payroll deduction.

The program works like an Individual Retirement Account (IRA) in some ways, and like a traditional pension in other ways. Like an IRA, a participant’s account balance accrues with contributions and investment earnings. Also, accounts are completely portable, so workers can take their benefits from job to job.

Like a pension, contributions are invested in a pooled, professionally managed fund administered by an oversight board. Also, the plan guarantees a minimum return on all investments—so workers are more protected from the volatility of Wall Street. And when workers are ready to retire, low-cost annuities would be provided, so they can receive a monthly check for the rest of their life, just like a defined benefit pension.<sup>16</sup>

In Massachusetts, a similar law was passed in 2012, although it is much more limited in scope—access to the system is limited to nonprofit employers with 20 employees or less. Similar bills have also been proposed or discussed in many other states in recent years, including Connecticut, Illinois, Maryland, Michigan, Pennsylvania, Rhode Island, Vermont, Virginia, Washington, West Virginia, and Wisconsin.<sup>17</sup>

## INTERNATIONAL PENSION SYSTEMS CAN PROVIDE MODELS TO IMPROVE THE U.S. SYSTEM

Other models to improve Americans’ retirement prospects can be found abroad. In many countries around the world, more workers are covered, and retirement benefits are higher.

Australia has a universal workplace retirement system, called the Superannuation Guarantee. Although Australia’s system is a DC program in which workers bear their own investment risk, the system is relatively strong because 1) coverage is near universal, and 2) employers must make a mandatory contribution that is substantial—currently, 9% of gross pay, rising incrementally to 12% of pay in 2019.

The Netherlands’ retirement system provides one of the highest replacement rates in the world. At its center is a DB plan which is funded primarily by employers. Most plans are integrated with the social security system to provide a target total benefit. Unfortunately, due to the market downturn, employers have recently attempted to shift some risks toward employees through the increased use “collective” DC plans, which work as a kind of hybrid between a DB and a DC plan.

In Canada, the centerpiece of their system is an employer-sponsored DB plan, but unlike Australia and the Netherlands, here the system is voluntary. As a result, Canada sees lower DB coverage. However, the country also has a highly progressive and generous social security system, as compared with the United States.<sup>18</sup>

All three countries provide relatively higher retirement income for low- and middle-wage workers through their social security and employer plans combined than does the United States. The three countries vary in the level of risk taken on by employees. However, in all three countries, these risks are either largely borne by the employer or pooled among all workers. Thus, employees individually face far lower risk than in the current U.S. system. The lower the risk, the easier it is for workers as a group to achieve a financially secure retirement.

### OVERVIEW OF SELECTED INTERNATIONAL WORKPLACE RETIREMENT SYSTEMS<sup>19</sup>

	Australia	Canada	Netherlands	United States
<b>Coverage Rate</b>	95%	32%	95%	40%
<b>Mandatory</b>	Mandatory	Voluntary	Quasi-	Voluntary
<b>Predominant Plan Type</b>	DC	Final Pay DB	Average Pay DB (but moving to hybrid)	DC
<b>Primary Source of Retirement Benefit?</b>	Yes	No	Yes	No

<b>Role of Individual Account (i.e. DC plan)</b>	Minor	Important	Minor	Dominant
<b>Tax Deductible Employee Contributions</b>	No, but taxed at reduced rates	Yes	Yes	DB: No DC: Yes

The bottom line is, while all pension plans—including those abroad and in the public sector—have faced financial challenges in recent years, they remain the most cost-effective way to fund an adequate and secure retirement for employees. Nonetheless, many Americans currently have no access to effective retirement savings plans at work. Consequently, some policymakers are looking to the public pension system, as well as several international models, to offer a new solution for more Americans to retire with dignity after a lifetime of hard work.

<sup>1</sup> Lambert, L. 2013. U.S. public pension investments jump, costs surge too. *Reuters*, September 23.

<sup>2</sup> Oliff, P., C. Mai, and V. Palacios. 2012. *States Continue to Feel Recession's Impact*. Washington, DC: Center on Budget and Policy Priorities.

<sup>3</sup> National Conference of State Legislatures. *Actions & Proposals to Balance the FY 2010 Budget: State Employee Actions, Furloughs and Layoffs*. Washington, DC: National Conference of State Legislatures.

<sup>4</sup> Martel, L. and Rivale, T. 2013. *State Retirement Reform Legislation: NCSL Legislative Summit*. Washington, DC: National Conference of State Legislatures.

<sup>5</sup> Munnell, A.H., J.P. Aubrey, A. Belbase, and J. Hurwitz. 2013. *State and Local Pension Costs: Pre-Crisis, Post-Crisis, and Post-Reform*. Chestnut Hill, MA: Center for Retirement Research at Boston College.

<sup>6</sup> Michigan House Fiscal Agency. 2010. *Legislative Analysis: A Summary of Senate Bill 1227 as Enacted*. Michigan House Fiscal Agency.

<sup>7</sup> Snell, R. 2012. *Pensions and Retirement Plan Enactments in 2012 State Legislatures*. Washington, DC: National Conference of State Legislatures.

<sup>8</sup> Utah Retirement Systems. No date. URS Senate Bills.

<sup>9</sup> Snell, R. 2012. *Pensions and Retirement Plan Enactments in 2012 State Legislatures*. Washington, DC: National Conference of State Legislatures.

<sup>10</sup> Fornia, W., and Almeida, B. 2008. *A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Plans*. Washington, DC: National Institute on Retirement Security.

<sup>11</sup> Center for State and Local Government Excellence. 2011. *Fact Sheets on States with Defined Contribution Pension Plans, 2011: Michigan School Employees*. Washington, DC: CSLGE.

<sup>12</sup> Hiltonsmith, R. 2013. *Rhode Island's New Hybrid Pension Plan Will Cost the State More While Reducing Retiree Benefits*. Washington, DC: Economic Policy Institute.

<sup>13</sup> Cohn, S. 2010. Retirement on hold: American workers \$6 trillion short. *CNBC*, September 15.

<sup>14</sup> National Institute on Retirement Security. 2009. *Raising the Bar: Policy Solutions for Improving Retirement Security*. Washington, DC: NIRS.

<sup>15</sup> Rhee, N. 2012. *6.3 Million Private Sector Workers in California Lack Access to a Retirement Plan on the Job*. University of California, Berkeley Center for Labor Research and Education.

<sup>16</sup> California Legislative Information. 2012. SB-1234 Retirement savings plans.

<sup>17</sup> Scott, D. 2012. State-run pensions for private-sector employees proposed. *Governing*. July 10.

<sup>18</sup> Turner, J.A., and N. Rhee. *Lessons for Private Sector Retirement Security from Australia, Canada, and the Netherlands*. Washington, DC: National Institute on Retirement Security.

<sup>19</sup> Turner, J.A., and N. Rhee. *Lessons for Private Sector Retirement Security from Australia, Canada, and the Netherlands*. Washington, DC: National Institute on Retirement Security.