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ALEC Issue Analysis

Bringing Pensions into the 21st Century: How to Modernize Public Pensions

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Facing labor shortages created by a graying workforce, state and local governments are asking themselves how to entice younger, more mobile employees to public service. This is not just a long-term problem. School districts in Dallas and Houston, for example, need to recruit 15,300 teachers to fill vacancies for the 2000-2001 school year.¹ One answer to this question is to modernize public retirement plans by offering workers a choice between traditional defined benefit (DB) pension plans and modern, fully portable defined contribution (DC) pension plans. In fact, offering DC pension plans, which are similar to popular 401(k) plans available to private sector employees, is a public policy solution that is gaining momentum in state legislatures across the country.

Recently the Florida Legislature, with the support of Governor Jeb Bush, enacted legislation to give 600,000 state and local employees this option. Nationally, however, most public employees have no choice but to enroll in DB pension plans, which promise fixed monthly payments for the life of the employee, much like a level payment annuity. By 1994, 91 percent of public workers were enrolled in these plans. In contrast, according to a survey done in 1997, 57 percent of private sector workers at medium and large firms were participating in DC plans.² Most public workers that do participate in DC plans do so through voluntary supplemental deferred compensation accounts. Public employers seldom match employee contributions to these accounts, so there is little incentive for employee participation.

In DB pension systems, actuaries calculate pensioners' benefits using complicated formulas that generally multiply the employee's final average salary and years of service by a small multiplier. Usually, it is the average salary for the last two or three years of work that is plugged in to this calculation. While defined benefit payments are generous for workers that spend 20 or 30 years with the same employer, shorter-term, younger workers are often short-changed by this system. For this reason, it is imperative that all public employees be given the opportunity to select the kind of plan that best fits their lifestyles.

There are many features of DC pension plans that make them attractive to public workers and an important human resources tool for employers. These features include:

On the Employer/Taxpayers' Side

- DC plans are good employee recruiting tools because portable retirement benefits and flexible retirement savings options are desirable, especially to younger workers;
- DC plans mean no future unfunded liabilities paid for by the taxpayers;
- More precise budgeting because employers are only responsible for contributing a defined percentage of their workers' salaries to these accounts;
- DC plans take much of the politics out of employer benefits budgeting, insulating taxpayers from underfunded pension systems unable to meet their benefit obligations.

On the Employees' Side

- DC plans give employees completely portable retirement benefits;
- Short vesting periods for employer contributions; More equitable and sometimes higher retirement benefits;
- More flexibility to decide what kind of investment portfolio meets their personal needs.

Although there are many benefits to offering DC pension plans, this article explores two, in particular: portability and helping working women.

Portable Benefits

Because they offer fully portable pension benefits, DC plans can make public jobs more attractive to prospective employees. In fact, according to a recent survey of firms that switched from DB to DC pension plans by Buck Consultants, the second most popular reason for making this change, according to respondents, was to accommodate employees who wanted the new plan.³

Most experts assert that the average employee will have a minimum of seven different jobs over his or her lifetime, making portability one of the most important advantages of DC plans.⁴ This prediction underscores the need for different retirement options, such as DC pension plans, that offer real portability in the public arena. This is important, especially for employees that want to move between the public and private sectors.

By Matt Lathrop, Director of the Commerce and Economic Development Task Force

The Milbank Memorial Fund published a study entitled "Pension Portability for State and Local Governments." This study presented hypothetical employment scenarios for mobile public officials. Each of these officials held several different positions over their careers, and all would have been better off in a DC pension plan because they each accumulated only a few years of service with each employer under the DB structure.

Some critics have argued that public employees will withdraw their DC pension benefits when they leave the system and spend them. However, studies indicate that the likelihood of this happening depends on the age of the employee. For example, one study found that while 48 percent of workers aged 35-44 roll over lump sum distributions, 73 percent of 55 to 64 year olds, with much higher account balances, with roll them over.⁵ Regardless, this concern could be mitigated in the plan design of the DC option.

Increasingly, as both private firms and state and local governments use new technology that requires higher degrees of specialization to understand, these two sectors will battle each other for well trained employees. Offering workers the option of selecting a DC pension plan will make government more competitive for these highly skilled employees.

Gender Equity

Women, a growing part of the workforce, benefit from DC plan characteristics. Women benefit from short vesting schedules, the absence of benefit formulae and the provision of portable retirement benefits. In a study by University of Wisconsin business professor Ramon Aldag completed last year, the professor found that a female University of Wisconsin faculty member that disrupts her career at age 30 could earn from 3 ½ to 5 ½ times more in retirement benefits with an optional, portable DC pension plan than she could in the DB system.⁶

Women are much more likely to have interrupted work histories than men, which was verified by the Wisconsin study. This means that women will receive fewer benefits than men in DB plans. For example, according to the Kansas Public Policy Institute, only 11 percent of women who begin working before they are 25 will earn benefits in the Kansas Public Employee Retirement System (KPERS).⁷ Women are also the victims of DB plan formulas because their salaries are lower, on average, than those of men. According to a 1998 Texas Pension Review Board, women in the Texas Teachers Retirement System (TRS) make \$4,100 less than men, on average, and have slightly fewer service credits. This results in a lower formula-driven DB benefit than women might expect from a DC plan if they could choose to participate in one.

It also appears that DC pensions are popular among women. In North Dakota for example, which just implemented an optional DC pension for non-classified workers, 44 percent of eligible women selected the new plan compared to 33 percent of men.⁸

State Legislative Activity

State legislatures are increasingly considering optional DC pension plans to enhance their overall benefit packages. Besides Florida, Ohio, South Carolina, and Utah adopted a DC option for certain segments of their employee populations in 2000, including new employees. Since Michigan switched its state employee pension to a DC plan in 1997, North Dakota, Arizona, Colorado, Louisiana, Vermont and Virginia have all passed these plans for smaller segments of public workers. Montana enacted an optional DC plan for all its employees last year. Overall, more than twenty states are considering DC pension plans for segments of their workforces.

Conclusion

Every public employee deserves the opportunity to choose a retirement program that meets his or her personal needs and goals. Public employers, in turn, could use flexible retirement options as a carrot to attract younger, well educated workers to public service. ■

NOTES

1 Testimony of Pamela Tackett, State Board of Educator Certification, before the Texas House Committee on Pensions and Investments Subcommittee on Reemployment, April 10, 2000.

2 Lawrence E. Kochard, "The Transition from Defined Benefit to Defined Contribution Pension Plans in the Public Sector," The Kansas Public Policy Institute, January 2000, p. 3.

3 *Ibid.*, p. 5.

4 Dr. Edward T. Burton, III and Matthew Lathrop, "Modernizing Public Pension Systems: The Case for Defined Contribution Plans," The American Legislative Exchange Council, July 1999, p. 5.

5 Kochard, p. 6.

6 Dennis Chaptman, "UW wants to let new professors bring pensions with them: Legislator, system official say change would aid recruiting," Milwaukee Journal Sentinel, Wisconsin Section, September 2, 1999, p. 2B.

7 Burton and Lathrop, p. 6.

8 Information from NDPERS. For more information, please contact Sparb Collins, Executive Director
400 East Broadway, Suite 505, Box 1214, Bismarck, ND 58502 or call (800) 803-7377. The fax number is (701) 328-3920.

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