Are Traditional Pensions Helping States Attract and Retain the Best Workers?

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Urban Institute

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Key Features of Traditional Pension Plans

- Pay annuity from retirement until death (or death of spouse)
- Typical benefit formula sets payment equal to some fraction of final average salary times years of service
- Some plans cap benefits as share of final salary
- Benefits typically become available at particular age if worker has enough service and leaves the job
- Cost-of-living adjustments (COLAs) after retirement are common
- Most states require employee contributions
Implications of Traditional Pension Formula

- Real value of benefits erodes over time because it is not adjusted for inflation or interest from quit date until benefits are first paid

- Formula rewards additional work by raising the percentage of salary paid out and increasing final salary
  - rewards work more near the end of career than beginning

- Workers forfeit a month of benefits for each month that they remain on the job past the retirement eligibility date
Traditional Plans May Not Distribute Retirement Benefits Equitably across Workers

- Young workers do not accumulate many benefits
- The plan may lock-in middle-aged workers, even when they are not well suited to their jobs
- Some older workers face incentives to retire early
- Do these incentives make sense for the modern labor market?
  - workers are increasingly mobile
  - younger workforce is stagnating
Outline

• How does a typical state pension plan distort employee recruitment and retention?

• How would various reform options affect workforce incentives?
## Hypothetical Example of a Typical Public Employee Retirement Plan

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vesting</td>
<td>10 years</td>
</tr>
<tr>
<td>Percentage factor</td>
<td>1.8%</td>
</tr>
<tr>
<td>Years included in final average salary</td>
<td>Top 3</td>
</tr>
<tr>
<td>Eligibility for normal retirement</td>
<td>Age 60/10 years of service</td>
</tr>
<tr>
<td></td>
<td>Age 55/25 years of service</td>
</tr>
<tr>
<td>Eligibility for early retirement</td>
<td>Any age/25 years</td>
</tr>
<tr>
<td>Early retirement reduction (per year)</td>
<td>3%, before 55</td>
</tr>
<tr>
<td>COLA (% of change in CPI)</td>
<td>100%</td>
</tr>
<tr>
<td>Employee contribution rate</td>
<td>5%</td>
</tr>
</tbody>
</table>

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www.RetirementPolicy.org
Annual Pension Benefits as Percentage of Final Average Salary, Employee Hired at Age 25, by Retirement Age

<table>
<thead>
<tr>
<th>Retirement Age</th>
<th>Benefits Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>50</td>
<td>38%</td>
</tr>
<tr>
<td>55</td>
<td>54%</td>
</tr>
<tr>
<td>60</td>
<td>63%</td>
</tr>
<tr>
<td>65</td>
<td>72%</td>
</tr>
<tr>
<td>70</td>
<td>81%</td>
</tr>
<tr>
<td>75</td>
<td>90%</td>
</tr>
</tbody>
</table>

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www.RetirementPolicy.org
Annual Benefits Rise Steadily as Workers Stay on the Job Longer, but Lifetime Benefits Often Do Not

- Employees who work longer receive fewer years of benefits
- This lifetime value can be expressed by “pension wealth”
  - $PW = \text{expected value of the lifetime stream of future benefits}$
- That calculation depends on various assumptions
  - interest rate, inflation rate
  - earnings growth
  - mortality
- Spikes and sharp drops in pension wealth can distort retention decisions
Employer Pension Wealth as Multiple of Annual Salary for Employee Hired at Age 25, by Age

Wealth spikes when worker qualifies for early retirement

Wealth soon begins to decline after early retirement penalty disappears

Wealth spikes when benefits vest

Note: Pension wealth is calculated net of employee contributions.
Addition to Employer Pension Wealth from Working Another Year as % of Salary, Tier 1, Hired at Age 25

Note: Pension wealth is calculated net of employee contributions.

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Worker qualifies for early retirement

Benefits vest

Early retirement penalty disappears

Pension wealth falls with additional work

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Average Annual Addition to Employer Pension Wealth from Working from Ages 60 to 65, By Age of Hire

<table>
<thead>
<tr>
<th>Age of Hire</th>
<th>Average Addition</th>
</tr>
</thead>
<tbody>
<tr>
<td>25</td>
<td>-39%</td>
</tr>
<tr>
<td>30</td>
<td>-31%</td>
</tr>
<tr>
<td>35</td>
<td>-23%</td>
</tr>
<tr>
<td>40</td>
<td>-14%</td>
</tr>
<tr>
<td>45</td>
<td>-6%</td>
</tr>
<tr>
<td>50</td>
<td>3%</td>
</tr>
</tbody>
</table>

Note: Pension wealth is calculated net of employee contributions.
Outline

- How does a typical state pension plan distort employee recruitment and retention?
- How would various reform options affect workforce incentives?
Can Reforms Improve Workforce Incentives?

- Can policy reforms smooth the growth in pension wealth over the career and better distribute benefits?
  - better reward younger workers
  - reduce lock-in of mid-career workers
  - better reward older workers

- Parameters that could be changed include:
  - contribution rates
  - vesting period
  - normal and early retirement ages
  - earnings base
Raising Employee Contribution Rates Reduces Rewards for Younger Workers

Employer Pension Wealth (net of employee contributions) as Multiple of Annual Salary for Employee Hired at Age 25, by Age

5% employee contribution rate

10% employee contribution rate
Raising the Normal Retirement Age (NRA) Boosts Work Incentives for Some Older Employees

Employer Pension Wealth (net of employee contributions) as Multiple of Annual Salary for Employee Hired at Age 25, by Age

NRA = age 60/10 yrs, 55/25

NRA = age 65/10 yrs, 60/25

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Eliminating Early Retirement Shifts the Wealth Spike to Older Ages

Employer Pension Wealth (net of employee contributions) as Multiple of Annual Salary for Employee Hired at Age 25, by Age

Early Retirement after 25 years

No Early Retirement
Raising Benefits for Those who Work Longer Boosts Rewards for Older Workers

Employer Pension Wealth (net of employee contributions) as Multiple of Annual Salary for Employee Hired at Age 25, by Age

baseline

Raising benefits 5%/year after age 55
### Summary of Impact of Reforms on Incentives for Young, Middle-Aged, and Older Workers

<table>
<thead>
<tr>
<th>Policy Option</th>
<th>Reward Young</th>
<th>Lock in Middle-Age</th>
<th>Reward Old</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase contribution rate (5% to 10%)</td>
<td>worse</td>
<td>worse</td>
<td>worse</td>
</tr>
<tr>
<td>Base benefits on career earnings</td>
<td>no change</td>
<td>no change</td>
<td>worse</td>
</tr>
<tr>
<td>Increase normal retirement age (NRA)</td>
<td>worse</td>
<td>worse</td>
<td>better, up to new NRA</td>
</tr>
<tr>
<td>Eliminate early retirement (ERA)</td>
<td>no change</td>
<td>better</td>
<td>better, up to NRA</td>
</tr>
<tr>
<td>Increase NRA and eliminate ERA</td>
<td>worse</td>
<td>better</td>
<td>better, up to new NRA</td>
</tr>
<tr>
<td>Raise benefits if work longer (5%/yr after 55)</td>
<td>no change</td>
<td>better</td>
<td>better</td>
</tr>
</tbody>
</table>
Look for our Upcoming Pension Report Card in September

- www.urban.org
- Grades plans on how well they reward younger and older workers and how much they lock-in career workers
- Covers all 50 states and District of Columbia
- Covers key occupations and most tiers
  - teachers
  - police/fire
  - general state employees
  - general local employees