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NEW LOUISIANA RETIREMENT PLAN IS BAD FOR WORKERS AND TAXPAYERS

Cash balance plan increases retirement insecurity without offering any savings

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With Congress mired in partisan gridlock, states are serving as laboratories for retirement policy as well as other policy areas. While some states are making positive strides, others are moving in the wrong direction. Among the latter is Louisiana, where a bill signed earlier this year by Gov. Bobby Jindal will switch many newly hired state and local government workers from traditional defined benefit pension plans to a cash balance plan starting in 2013.

Public-sector workers in Louisiana are not covered by Social Security. However, the current Louisiana public pension system provides death and disability benefits as well as a traditional retirement pension based on a worker's salary and years of service. Thus, participants in the current system can count on fixed payments in retirement, regardless of stock market performance. Under the new system, participants will accrue retirement savings in accounts that earn a variable rate of return, similar to 401(k) accounts. Thus, there is no way for participants in the new system to know in advance how much they will have upon retirement.

Though many private-sector workers face investment risks with 401(k)s, they can at least rely on Social Security to provide a guaranteed base retirement income. In addition, most 401(k) participants have the option of investing their savings in fixed-income securities, accepting a lower expected rate of return in exchange for reduced risk. In contrast, participants in the new cash balance plan will not have the option of investing conservatively, though they will be protected against outright losses on investments.

This policy memo outlines a number of reasons why Louisiana's new cash balance pension system should not serve as a model for other states:

- It does not address the issue of unfunded liabilities caused by the failure by public officials to keep up with required contributions.
- It is not projected to save taxpayers money and could actually cost more. In addition to implementation costs and potential employee turnover costs, the cash balance plan may induce a shift to more conservative and liquid investments, dragging down investment earnings for the system as a whole.
- It burdens state and local government workers with many of the same risks as private-sector workers with 401(k)s, but without Social Security as a fallback—leaving many public-sector workers in Louisiana at risk of poverty in old age.
- It increases financial risks for workers who become disabled before retirement and family members of workers who die before retirement.

How the current defined benefit pension system works

Under the current defined benefit pension system, workers can count on a fixed payment in retirement based on pre-retirement wages and years of service, regardless of stock market performance. For regular state employees participating in the Louisiana State Employees' Retirement System (LASERS), the largest group of workers affected by the changes, pension benefits equal 2.5 percent of a worker's final average salary multiplied by years of service, where "final average salary" refers to the highest-paid five years of service, usually the last five years. Thus, a worker with a final average salary of around $40,000 will have a replacement rate of 75 percent after 30 years, or $30,000 per year.[1] The average pension for rank-and-file LASERS retirees is considerably lower—around $19,000—because most of these retirees had lower salaries or fewer years of service (LASERS 2011).

The normal cost of the current system is 12 percent of pay, with workers contributing two-thirds (8 percent) and employers contributing one-third (4 percent), which is less than what employers contribute under Social Security.[2] However, if investment returns are higher or lower than the assumed rate of return (now 8 percent, previously 8.25 percent), the employer contribution is adjusted to gradually close the projected shortfall or eliminate the projected surplus. Though the assumed rate of return is expressed in nominal terms (8 percent), it is the real (inflation-adjusted) assumed rate of return that matters: 5 percent. To put this in perspective, the Congressional Budget Office projects long-term real interest rates on Treasury bonds (considered a risk-free investment) to be 3 percent (CBO 2012), which means the funds' real assumed rate of return on a balanced portfolio of stocks, bonds, and other assets is only two percentage points above what is known as the risk-free rate.

The system is currently underfunded, in part due to the market downturn of 2007–2009. However, the bulk of the shortfall has nothing to do with poor investment returns but rather a failure by public officials to keep up with actuarially required employer contributions. Since the switch to a cash balance plan does not address the issue of unfunded liabilities, state and local governments will have to make the same payments to close the shortfall under both the current defined benefit system and the new cash balance plan.

How the new cash balance plan works

The changes take effect in 2013 and apply to newly hired workers. The affected workers are rank-and-file (non-hazardous duty) members of the Louisiana State Employees' Retirement System (LASERS) and members of the Teachers' Retirement System of Louisiana (TRSL) employed in higher education. Other public-sector workers, including K–12 teachers in TRSL and members of the Louisiana School Employees' Retirement System (LSERS), may opt into the cash balance plan.

Under the cash balance plan, workers will contribute 8 percent and employers will contribute 4 percent of pay to savings accounts, though funds will be commingled with existing LASERS, TRSL, and LSERS assets. The cash balance accounts will receive an interest credit equal to the pension funds' rate of return minus 1 percent, or 0 percent, whichever is higher.

Legally, a cash balance plan is considered a defined benefit plan like the current pension plans rather than a defined contribution plan like a 401(k). In practice, cash balance plans are hybrids which may have more in common with either defined benefit or defined contribution plans depending on the specifics of each plan. The Louisiana cash balance plan has some features in common with traditional defined benefit pension plans: Employer contributions are not contingent on voluntary employee contributions, funds are pooled and professionally managed, and benefits are normally paid out in the form of an annuity rather than a lump sum. However, unlike some cash balance plans that provide fixed interest credits, the Louisiana cash balance plan is closer to a defined contribution plan because the contribution is defined in advance and benefit payments can vary significantly depending on investment earnings.

Another feature cash balance plans have in common with defined contribution plans is that benefits are based on contributions and interest credits rather than being tied to a worker's final salary, as with most, though not all, traditional defined benefit pensions. In contrast, the current defined benefit system promotes employee retention because service credits are more valuable when multiplied by end-of-career salaries than mid-career salaries.

Impact on workers

The new cash balance plan greatly increases risks for workers. Among those at greatest risk of financial hardship are workers who become disabled before retirement and family members of those who die before retirement. Under the current defined benefit system, participants with 10 or more years of service are eligible for unreduced pension benefits if they become disabled, as if they were retiring at the normal retirement age. Likewise, the current system provides survivor benefits to family members similar to those provided under Social Security (Richmond 2012). Under the cash balance plan, workers and their families will receive no additional benefits to compensate for the loss of a breadwinner beyond early access to accrued retirement savings. The disability benefit under the defined benefit system is almost twice as much as disabled workers would receive under the cash balance plan when they first become eligible for benefits, though the difference narrows as workers approach the normal retirement age and varies depending on investment returns credited to cash balance participants.[3]

For healthy workers who retire around the normal retirement age, the biggest drawback of the cash balance plan is that their retirement income will be subject to the vagaries of financial markets, with benefits varying significantly depending on whether workers retire in the wake of bull or bear markets. Though the new cash balance plan protects participants against investment losses, this protection is limited because the bulk of retirement income in all advance-funded retirement plans derives from positive investment earnings, with losses a relatively infrequent occurrence. Nationwide, investment earnings represented 61 percent of state and local pension fund revenues between 1982 and 2010 (NASRA 2012). State and local pension funds experienced aggregate losses in only three of the last 18 years, and Louisiana funds had losses in only two years (author's analysis of U.S. Census Bureau 1993–2011a).

Though average benefits will be comparable under both systems, cash balance benefits will vary considerably depending on the year of retirement, causing retirement insecurity even among middle-class, long-career workers. Thus, under reasonable assumptions, roughly 1 in 4 cash balance plan participants retiring after 30 years of service will fail to replace even half of their pre-retirement earnings. One in 20 middle-income workers retiring after 30 years will end up with retirement income below the official poverty line for two-person senior households ($13,600) (U.S. Census Bureau 2011), with the odds of ending up in poverty higher for those with shorter tenures or lower earnings. Though the median annuitized benefit for a middle-income earner will be around $26,000 per year after 30 years (a replacement rate of around 65 percent based on a final average salary of $40,000), roughly one-fourth will have retirement incomes below $17,000, and one-fourth will have retirement incomes above $40,000.[4]

Though the preceding analysis is based on simulated returns, a similar exercise based on historic returns found that workers retiring during bull markets could have retirement account balances almost three times as large as the account balances of workers retiring during bear markets (Burtless 2008). This does not take into account the Louisiana cash balance plan's guarantee against losses, which somewhat reduces participant risk. Nevertheless, it shows that much of the risk in individual accounts is due to the timing of retirement rather than individual investment choices.

Benefits will also be smaller or larger depending on age and years of service. Generally, career workers who leave employment around the normal retirement age will tend to fare worse under the cash balance plan, because the current benefit structure is designed to promote employee retention. Conversely, mobile workers who leave employment before the normal retirement age will tend to fare better, on average.[5] However, this does not take into account the element of luck that will leave some mobile workers worse off and some career workers better off under the new system, as all workers face increased uncertainty.

Mobile workers' retirement security also depends on whether they cash out their accounts before retirement. The cash balance plan encourages job leavers to take lump sum payouts because those who opt for an annuity do not earn interest on their account balances between the time they leave and the normal retirement age. In contrast, the current defined benefit system discourages cash-outs by refunding only the employee's contributions without interest, as opposed to paying the full accrued pension benefit at the normal retirement age.

Impact on taxpayers

Since the average value of benefits is the same under both systems, the cash balance plan is not expected to save taxpayers money, though it will reduce taxpayer risk by shifting it onto workers. If anything, the cash balance plan will likely cost taxpayers more than the current system by affecting employee recruitment, retention, and retirement; by prompting a shift toward more conservative and liquid investments; and by introducing an element of gamesmanship to retirement decisions.

Contributions to retirement plans

The cash balance plan is not projected to reduce taxpayer-financed contributions to retirement plans. An analysis by the Louisiana legislature's pension actuary found that the one-percentage-point difference between actual investment returns earned by the pooled pension funds and the interest credited to cash balance accounts will be consumed by the cost of guaranteeing these accounts against losses (Richmond 2012). Meanwhile, implementation costs will add to short-term outlays.

Long-run projections depend on the accuracy of the rate-of-return assumption (8 percent), which is in line with the funds' historical performance. The actual cost of the new cash balance plan to taxpayers may be higher or lower than the current defined benefit system depending on investment returns going forward. If returns are much higher than assumed, the new system will tend to be more expensive than the old system because cash balance participants, unlike participants in the defined benefit system, receive more generous benefits in boom times. Conversely, if investment returns are the same as or lower than assumed but still generally positive, the cash balance plan will tend to be cheaper than the defined benefit system, and cash balance participants will fare worse than defined benefit participants because the interest credited to cash balance participants is one percentage point lower than realized returns on pension fund assets. Finally, if investment returns are more volatile, the new system will be more expensive than the old system because there is a floor but no ceiling on the interest credited to cash balance accounts.

Investment risk

By tying pension payments to the funds' returns on investment, the new cash balance plan shifts financial risk from public employers (and ultimately taxpayers) to individual workers and their families. However, this is not likely to benefit taxpayers in the long run because the risks to taxpayers under the current system are already modest, whereas the risks to workers under the new system are large and will presumably require offsetting pay increases to attract and retain the same quality of workers.

This asymmetry results from pension funds' ability to absorb year-to-year fluctuations in investment returns, so that benefits under defined benefit plans can be based on average investment returns. Because only a small portion of state and local government pension fund assets (7.5 percent in 2010) is needed to pay benefits in any given year (author's analysis of U.S. Census Bureau 1993–2011a), pension funds can easily handle year-to-year fluctuations in investment returns.

Though taxpayers do face the risk of a long-term decline in investment returns under the current system, it is important to remember that employers currently pay only 4 percent of payroll toward normal costs, less than what most employers pay for Social Security (6.2 percent) and significantly less than they pay for Social Security, retirement, and disability benefits (13.4 percent) (author's analysis of LASERS 2012 and U.S. Bureau of Labor Statistics 2012). As a result, even if long-run returns are lower than projected, the normal employer contribution under the current defined benefit system will still be low compared with what most employers pay, especially large employers. In other words, while the risk to taxpayers is real, it is modest compared with the risk that elected officials will neglect to pay required contributions, a problem the cash balance plan does not address.

Workforce considerations

The current pension system serves as an effective human resource tool for recruitment, retention, and orderly retirement. Under the new cash balance plan, employers will no longer be able to attract and retain workers with the promise of a secure pension, an important benefit given that public-sector jobs generally pay less than private-sector jobs (for example, see Allegretto, Corcoran, and Mishel 2004, 2008, 2011; Bender and Heywood 2010; Keefe 2010; Munnell et al. 2011; Schmitt 2010). In addition, the cash balance plan will not encourage employee retention by tying benefits to a worker's final average salary, and thus will increase training and other turnover costs.

It will also be more difficult for public-sector employers to manage the transition to retirement around a normal retirement age. Under the cash balance plan, the timing of retirement will be affected by financial markets, as workers are encouraged to postpone retirement when the stock market and economy are depressed and to retire when the labor market is tight and recruiting replacements is more difficult. This will not only make life difficult for employers, it will also have a pro-cyclical effect on the state's economy, exacerbating economic downturns and unemployment. Though this destabilizing effect initially will be small, it could become a real problem as the system expands or is replicated elsewhere.

Portfolio allocations and adverse selection problems

Cost and risk considerations could influence portfolio allocations. If pension funds shift toward more conservative investments to limit cash balance participants' risk exposure or to minimize the cost of the guarantee, this would lower returns not just for cash balance participants but for the system as a whole. In addition, an increase in employee turnover and cash-outs could prompt a shift toward more liquid investments, further eroding returns.

The cash balance plan also introduces what are known as adverse selection problems that allow participants to game the system. The normal cost of the current defined benefit system is based on workforce projections that reflect historical patterns of worker turnover. However, if mobile workers disproportionately opt into the cash balance plan and career workers elect to stay in the defined benefit system, this will drain resources from the system as workers self-select into the plan that gives them higher benefits. A similar problem will occur as participants have the option of taking either lump sum or annuitized benefits, with healthier participants more likely to opt for lifetime annuities. Though both options are also available under the defined benefit system, the current system minimizes this problem by providing a strong financial disincentive for lump sum payments. To make matters worse, these and other retirement decisions could be influenced by interest rates and other financial variables in ways that are hard to predict.

Conclusion

The current defined benefit system does not provide workers with lavish pensions. The average annual benefit—around $19,000 for regular LASERS members—is modest, especially considering that government workers tend to be better educated on average than workers overall and that Louisiana government workers are not covered by Social Security. And because workers shoulder two-thirds of the cost, the normal employer contribution is minimal—less than employers would be contributing to Social Security.

The projected cost of the cash balance plan is, if anything, higher than that of the current system. In addition to implementation costs and costs associated with increased turnover, the cash balance plan may induce a shift to more conservative and liquid investments, dragging down investment earnings for the system as a whole. It also introduces adverse selection problems that allow participants to game the system.

In theory, cash balance plans benefit mobile workers. In practice, because many workers drain their accounts when they switch jobs, it is not clear that these plans improve retirement security for these workers, especially given the element of luck introduced by volatile investment returns. In any case, failing to provide a retention incentive for experienced workers is a disadvantage from an employer or taxpayer perspective. Furthermore, if the switch to a cash balance plan is motivated by a concern for the retirement security of mobile workers, traditional pension benefits can also be based on career earnings rather than final average salaries.

The cash balance plan does not address the real problem, which is a failure by public officials to keep up with required contributions. Instead, it addresses a minor problem, taxpayer risk, even though pension funds are designed to absorb volatility in investment returns and have historically met or exceeded assumed returns.

Under the cash balance plan, even long-career middle-income workers run a real risk of hardship in retirement. Many families will end up with less than they would have with Social Security, especially those who would have qualified for disability or survivor benefits. Workers and their families who fall into poverty or near-poverty will not be the only ones to suffer: Taxpayers will also face higher taxes to pay for safety net programs.

If the cost is the same or higher, why the switch to a system that will greatly exacerbate retirement insecurity? Individual account-type plans have become a favorite of conservative policymakers and intellectuals, with origins in the Social Security privatization debate. Though organizations like the American Legislative Exchange Council (ALEC) have reportedly begun advocating in favor of cash balance plans as a compromise between traditional defined benefit pensions and defined contribution plans (Alford 2012), the Louisiana model shows that the result may be closer in practice to a 401(k) plan than to a traditional pension. Hostility to government and unions may be the motivating force for some proposed changes to public employee benefits. In particular, conservative critics have exaggerated taxpayer risk in order to inflate estimates of public-sector pay, deflecting attention from the failure of the 401(k) model (Morrissey 2012). In short, the Louisiana cash balance plan offers few advantages and many disadvantages and should not serve as a model for reformers in other states.

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Endnotes

1. This is based on an average salary of around $43,000 for regular LASERS members in 2012 and an annual pay increase of 4.3 percent (LASERS 2012).

2. The normal cost is the cost, usually expressed as a percent of payroll, of funding this year's portion of future pension benefits if assumptions about future investment earnings, wage growth, and other factors are correct. If a plan is underfunded, the actuarially required contribution is equal to the normal cost plus an amount sufficient to gradually amortize the unfunded accrued liability over a specified period. If a plan is overfunded, the required contribution will be less than the normal cost. If all assumptions are correct and a plan is fully funded, contributions equal to the normal cost will be sufficient to fund future pension benefits.

3. Author's analysis of prototypical workers hired at age 25 and 35 who become disabled after 10 to 30 years of service, assuming interest credits averaging 8 percent.

4. Based on 18 years of available data, the average rate of return on public pension fund assets in Louisiana was 8.1 percent, with a sample standard deviation (a measure of volatility) of 8.8 percent (author's analysis of U.S. Census Bureau data 1993–2011a). Using a technique called Monte Carlo simulation to generate random investment returns with the same mean and standard deviation, and using this to derive interest credits for the cash balance plan that are one percentage point lower or zero (whichever is higher), the average rate of return under the cash balance plan will be roughly the same—if anything, slightly higher—with a standard deviation of around 7.3 percent. All estimates are based on a final five-year average salary of $40,000, a 4.3 percent annual pay increase, and a 20-year expected retirement.

With a steady 8.0 percent return, a 30-year-tenure cash balance participant would achieve a replacement rate of around 72 percent. However, volatility drag lowers cumulative earnings if returns fluctuate.

5. Workers with less than five years' tenure are not affected one way or another because they are simply refunded their contributions under both systems.

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