State and Local Pension Plan in the United States

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Key Observations

- State and local plans began in US over one hundred years ago
- Most public workers also covered by SS
- Historical plans were DB but times are changing
- Major changes in DB plan design

Key Observations

- Funding issues are causing a major review of public pension plans
- Estimates of unfunded liabilities for public pensions range from $1 to $3 trillion
- State and local government budgets under pressure leads to closer review of benefit costs

History of Public Plans

- Late in the 19th century, large cities began offering retirement plans for teachers, police and firefighters
- Adoption of early plans linked to civil service reform and the end of political patronage in most municipal jobs

History of Public Plans

- First state plan for general employees, Massachusetts in 1911
- New York adopted a plan in 1921
- At the start of Depression, 22 states had adopted plans

History of Public Plans

- Social Security established in 1935 but public employees were excluded;
- However, SS served as a stimulus for state and local governments to develop their own plans
- More than additional 20 states established plans between 1935 and 1955

History of Public Plans

- During the 20th century, local plans for teachers were merged into statewide retirement systems for public school teachers
- Some large cities with mature plans remained outside of these state managed plans
- In many states, teacher plans were merged with plans for general state employees, now about half of the states have plans covering both teachers and civil servants

History of Public Plans

- Last state to establish a retirement plan for its general state employees was South Dakota in 1967
- Today, virtually all full time public employees are covered by an employer plan
- Prior to 2000, public plans were usually DB plans

Social Security and Public Pension Plans

- SS established in 1935
- Public employers and employees specifically excluded from participating in SS
- In 1950s, a series of amendments allowed public employees to be included in SS

Social Security and Public Pension Plans

- Most state and local governments entered the SS system during the 1950s and 1960s
- However, general state employees remain outside of SS in Alaska, Colorado, Louisiana, Maine, Massachusetts, Nevada, and Ohio
- Teachers in California, Connecticut, Illinois, Kentucky, Missouri, and Texas also do not participate in SS

Social Security and Public Pension Plans

- Public plans that include workers covered by SS are less generous compared to plans whose participants are not covered by SS
- In general, non SS plans provide retirement benefits that are about 10% higher than SS covered plans

Development of Pensions in Private Sector

- Private pensions also began in the U.S. in the late 19^{th} century
- Gradual expansion, about 15% of private employees covered by 1950 rising to 50% by mid-1970s
- Plans were primarily DB

Development of Pensions in Private Sector

- Passage of ERISA in 1974 produces a fundamental change
- Sharply increases cost of DB plans relative to DC plans, especially for small employers, due to cost of complying with the regulations
- Begins a long and continuing shift to DC plans

Development of Pensions in Private Sector

- Trend to DC also affected by:
  - Greater mobility of labor force
  - Fewer workers expecting to work for same employer for entire career
  - Layoffs and plant closings
  - Employers concerned about volatility of funding
  - Development of 401(k) plans

Why did public plans remain DC?

- Not subject to ERISA, thus lower administrative costs
- More stable employment
- Self selection of workers interested in career employment
- Greater level of unionization

Public Plans in 21st Century

- New developments since 2000
  - Significant concerns about unfunded liabilities
  - Rising cost of public pensions
  - Economic downturn
  - Comparison to private plans and reactions of tax payers

Public Plans in 21st Century

- Major changes occurring in public plans
  - Shift to DC as primary plan
  - DC plans as option to DB plans
  - DB/DC combination plans
  - Reform of DB plans

DC only

- A few states have eliminated DB plan for public employees
  - Michigan in 1997
  - Alaska in 2006
  - Nebraska shifts from DC to cash balance
  - Utah in 2011

DC option to DB

- Trend toward offering both DC and DB and letting workers choose
  - Ohio in 1998
  - Montana in 1999
  - North Dakota in 1999
  - Florida in 2000
  - South Carolina in 2000
  - Colorado in 2006

DC option to DB

- In most of these plans, DB is the default
- Many of the public employers give workers the opportunity to switch plans at some point
- Most employers try to make plans of equal value/cost

DB/DC Combination Plans

- These plans tend to have a lower generosity parameter for the DB component, for example, state switches from a 2% per year formula to a 1% per year formula
- The smaller DB plan is combined with a mandatory DC plan with perhaps a 6% contribution plan
- DB plan is often financed by employer with DC plan based on employee contributions

DB/DC Combination Plans

- States with combination plans include:
  - Indiana for several decades
  - Washington in 1998
  - Ohio in 2000
  - Florida in 2000
  - Oregon in 2003
  - Georgia in 2008

Reforming DB plans

- Increase in FAS period
  - Louisiana in 2005
  - Kansas in 2007
  - North Dakota in 2007
  - Rhode in 2009

Reforming DB plans

- Lower multiplier
  - Rhode Island in 2009
  - Nevada in 2009

Reforming DB plans

- Raising normal retirement age
  - Louisiana in 2005
  - Colorado in 2006
  - North Dakota in 2007
  - New Jersey in 2007
  - Kentucky in 2008
  - Nevada in 2009
  - Texas in 2009

Reforming DB plans

- Anti-spiking rules
  - Louisiana in 2005
  - Colorado in 2006
  - Iowa in 2006
  - Kansas in 2007
  - Nevada in 2009
  - Georgia in 2009

Reforming DB plans

- Reducing or eliminating COLAs
  - Alaska
  - Colorado
  - Missouri
  - Kansas
  - Georgia
  - Kentucky

Reforming DB plans

- Longer vesting periods
  - Mississippi in 2007
  - North Dakota in 2007
  - New York in 2009

Reforming DB plans

- Increased employee contributions
  - Kansas in 2007
  - New Hampshire in 2009

Reforming DB plans

- Formation of study commission
  - Colorado
  - Illinois
  - Iowa
  - Massachusetts
  - North Carolina
  - Ohio
  - Rhode Island
  - Vermont

Problems in Reforming Public Retirement Plans

- Most states have legal provisions against changes in retirement benefits for current workers – maybe in constitution, statutes, case law or union contracts
- Thus, most changes are applied only to new employees
- Therefore reforms have only minor impact on current costs and liabilities

Future of State and Local Pensions

- SS reform and its impact on employer pensions
  - Higher normal retirement age for SS
  - Lower benefits
  - Higher taxes

How will public employers respond?

Future of State and Local Pensions

- Changes in financial markets and cost concerns
  - Lower assumed (and realized) rates of return
  - Greater annual required contributions
  - Larger unfunded liabilities
  - Possibility of exhausting trust funds

How will state and local governments respond?