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The Staying Power of Pensions in the Public Sector

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The recession that has gripped California's economy has created intense pressures on public sector budgets, where officials are forced to meet demands for greater services in the face of declining tax revenues. Pressure on employee compensation, especially retirement benefits, is growing. The falling stock market has damaged the value of assets set aside in state and local pension funds. In turn, this may intensify efforts by taxpayer groups to dismantle traditional "defined benefit" (DB) pension programs for public employees.

But policymakers would be wise to proceed with caution. Employers — whether in the public or private sectors — use retirement plans to create incentives that enhance their human resources objectives. DB pensions are an effective retention tool, and government employers are well-suited to offer them. At the same time, DB pensions are highly valued by public sector employees. Moreover, as other states have learned, replacing a DB plan with a system of individual retirement savings accounts can have unintended consequences.

This article explores why DB plans have "staying power" in the public sector, from the perspective of employers, employees, and taxpayers. It concludes that pensions are an effective way to meet the objectives of all three stakeholder groups, suggesting that the public sector ought not to mimic the private sector trend away from DB pensions.[1]

Employer Motivations to Offer Retirement Benefits

The principal goal of a retirement plan is simple: to provide benefits that will enable employees to cease working at some point and have a source of support for the remainder of their lives. In the public sector, an adequate retirement income is important because the state, as the provider of social assistance for

those in need, ultimately will be responsible for those who can no longer work and meet basic needs. Thus government employers (and thus, taxpayers) can either "pay now" through an adequate retirement plan for their workers or "pay later" in the form of public assistance. This concern — for the well-being of elderly state and local employees — was a primary factor in the establishment of public retirement systems. During the Great Depression, Social Security was established for most private sector workers. But the act did not cover government employees so many states developed their own retirement systems for their public servants.[2]

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But the social goal of providing for retirement security is not the sole factor in designing retirement benefits. Workplace retirement plans are a "fringe benefit" that enhance the overall value of employee compensation. They differ from other fringe benefits in an important respect: they are deferred compensation. Unlike wages, paid vacation, or health care, retirement benefits are not enjoyed until years or even decades later.

Because of their deferred nature, retirement benefits encourage employee commitment to the employer. For instance, where long-tenured workers earn benefits more rapidly the longer they stay on the job, retention can be higher. For example, in the traditional "final pay" DB pension plan, the employee's retirement benefit is typically determined by a simple formula: the employee's final salary (usually averaged over the final 3-5 years of employment) is multiplied by their number of years of service, and then by a set factor or "benefit multiplier." In 2006, the median benefit multiplier for statewide pension plans was 1.85 percent.[3] In that case, an employee with a final average salary of $50,000 and 30 years of service will receive an annual benefit of $50,000 x 30 x 1.85 percent, or $27,750.

The longer one stays on the job, the more benefits one earns. In addition, the value of the pension grows with each pay increase. This is the dominant type of plan in the public sector — and 92 percent of public sector workers are covered by a DB plan.[4]

It is expected that employers would opt for this type of plan where retention is most valued, for example, where workers' productivity increases with their tenure or where recruitment costs are high and the employer wishes to keep turnover rates low. This type of plan also is desirable where workers make human capital investments that are not transferable to other employers or occupations. In those cases, the pension provides a "compensating differential" to make up for the fact that workers would incur labor market penalties by leaving their job. These descriptions fit jobs that make up the public sector workforce — from teachers, to public safety officers, to judges.

There also are settings where employers do not value retention as highly. These include jobs where productivity does not increase along with tenure, where turnover does not impose a large financial burden, or where employers value retention but have other ways to encourage it (e.g., job ladders, promotions, stock-based compensation). In those instances, an employer may not offer a retirement program, or provide a more "bare-bones" plan, or a plan where benefits steadily accrue over time (with no acceleration toward the end of one's career). Cash-balance defined benefit plans or defined contribution (DC) plans typically have more steady benefit accrual patterns and recently have become more common in the private sector.

Economists find strong evidence that DB pensions help retain workers. Turnover rates for workers with pensions are about half of those without pensions. One study showed that workers with pension coverage had an average tenure of 8.8 years at a single job; those without pension coverage stayed just 4.1 years.[5] There is a similar link between DB pension coverage and intent to stay with an emplyer — workers with a DB plan expect to remain on the job 5.5 to 7.5 years longer than workers with no pension.[6] DB pension plans exert significant retention effects, even controlling for worker demographics and employer characteristics.[7] This lower turnover is partially attributed to the "capital losses" incurred on exit — by leaving before retirement, workers

sacrifice a portion of the benefits they would have earned had they stayed on the job.[8]

In addition to a retention effect, there appears to be an attraction/selection effect involved. Workers who are more likely to stick with a job are more apt to take one that offers a DB pension plan in the first place. This could be because workers who are looking for a career (rather than just a short-term job) seek out employers who offer pensions. It also could be because employers who offer pensions are more careful in their hiring.

One study focuses on the attraction effect of pensions and considers how employers use retirement plan tools to select workers who are more forward looking. Workers who delay gratification and are less focused on immediate rewards are better, more attractive workers. Traditional DB pension plans, which hold out greater future rewards based on tenure, would be more attractive to these types of employees than to those who are more focused on current rewards.[9]

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Another study finds that both DB and DC plans have a positive effect on retention, but that the effect is significantly greater for DB plans.[10] DB pension plans "significantly increase employees' commitment to their organizations," while a DC plan has no effect on commitment. Interestingly, these results are strongest among younger workers, who often are assumed to favor DC plans. Employers looking for the best value for their compensation dollar should consider DB pension plans. The enhanced commitment effect of DB plans could translate to the bottom line through enhanced productivity.

DB pensions are an important tool for government employers, who have unique human resources objectives. Unlike private companies that exist to make a profit for shareholders, governments exist to provide essential services — safe streets, clean drinking water, good schools — to citizens and residents. Because government entities are more permanent than private sector firms, long-term attachments between employers and employees may be more feasible and more desirable.

Employment is much more stable in the public sector. In the private sector, layoffs and quits are three to four times higher than in the public sector.[11] Research shows that public sector employees are more attached to their jobs than private sector workers. The tenure of public sector employees actually has increased over the past 30 years, while tenure of private sector employees has decreased. By 2004, the median job tenure was 7.7 years for public sector employees, compared to 5 years for private sector employees.[12]

DB pensions provide incentives for highly skilled workers like researchers, computer programmers, or lawyers, to stick with public service instead of seeking better-paid positions in the private sector. Moreover, because many occupations in the public sector have few private sector counterparts (e.g. public safety, criminal justice), DB pensions provide incentives for non-transferable human capital investments. Thus, DB pension plans that effectively foster attachments between workers and their jobs are consistent with public sector employers' human resources goals.

How Public Employees View Pensions

A major difference between public and private sector workers is the relative importance placed on monetary and non-monetary rewards. Public employees are more likely to place a higher value on intrinsic rewards — feelings that their work is important and a sense of accomplishment — whereas private sector workers prioritize higher pay and fewer hours.[13] These differences in job preferences reveal the inherent nature of public sector organizations that are established to fulfill "complex social functions," supplying goods and services that cannot be bought and sold in a private market. For that reason, those who take public sector jobs place a higher value on acting for the good of their community, and the internal satisfaction these acts provide, than their private sector counterparts.[14]

That does not mean that compensation is unimportant. Public sector workers seem to care more about their retirement benefits than private sector workers, largely preferring DB plans to other forms of retirement income.[15] This is consistent with research that DB pension plans are more highly valued by certain kinds of workers — specifically, older workers and union members.[16] Public sector workers fit this description. In 2005, 52 percent of state and local workers were over age 45, as compared to just 43 percent of public sector workers. And public sector workers are more than three times as likely as private sector workers to be union members.[17]

Recent public opinion research reinforces that DB plans are highly valued by public employees and are an important consideration for those who choose a career in public service. For example, a 2006 nationally representative survey indicated that public employees were much more favorable to traditional DB pensions and much less likely than other workers to express a preference for 401(k)-type plans.[18] When asked about proposals to switch public employees out of DB plans and into 401(k)-type plans, public employees were strongly opposed.[19] A 2003 survey also found that public employees place a very high value on their pension programs.[20] Almost two-thirds of public sector employees stated a preference in favor of DB pensions as compared with DC plans.

But how do we know that these stated preferences are not just the result of employees being more familiar with the type of plan they already have? This "framing" effect can be real. Employers and retirement plan providers educate employees about the benefits they offer, so employees have more information about the available program than about alternatives. One survey found that workers and retirees expressed a preference for the type of plan they already had, be it a DB plan or a 401(k). Those who had both a DB and a DC plan were evenly split in their preferences.[21]

Another explanation is that public employees' preferences for DB pensions are "revealed" preferences — that is, they reflect a preference realized by deliberately seeking out an employer that offers this type of plan. Real world tests of this explanation indicate that it has merit. Time after time, when public sector employees are given a choice between a traditional DB pension and DC plan, they overwhelmingly choose the DB plan. In a small number of states, such as Ohio, Florida, South Carolina, Colorado, and Washington, public employees can choose whether to participate in a DB plan or a DC plan. Only 3.3 percent of employees in the Ohio Public Employee Retirement System elected the DC plan. In Florida and in South Carolina, DC take-up rates have been higher, with about one in five newly hired employees choosing the DC plan. However, there are distinct patterns along occupational lines. In South Carolina, those employed by the state's colleges and universities were three times more likely to opt for the DC plan. This may be because university employees are more likely to leave their jobs, or that they feel more comfortable managing their retirement plan money. In most states, employees who do not elect one plan or another default into the DB plan. The 80-90 percent DB take-up rates could be largely driven by inertia on the part of employees, a large number of whom do not make an affirmative choice. But the experience in Washington suggests otherwise. There the default option is a combined DB and DC plan, and almost two-thirds opted out of the default program in favor of an all-DB plan.[22]

Public sector workers seem to care more about their retirement benefits than private sector work-

The situation in West Virginia is even more interesting. In 1991, the Teachers Retirement System, a DB plan, was "frozen" to new hires — all teachers hired after 1991 were enrolled in a DC retirement plan, the Teachers Defined Contribution Retirement System.[23] Over time, it appeared the DC plan did not enable teachers to accumulate sufficient savings for retirement.[24] In 2005, the state closed the DC plan, and all newly hired teachers were enrolled in the "old" DB plan.[25] Then came the question of what to do about the teachers hired between 1991 and 2005 who had been enrolled in the DC plan. Initially, the idea was to transition all these teachers into the DB plan, but in the face of legal challenges, this route was abandoned. Subsequently, the state determined

that teachers would make individual elections whether to remain in the DC plan or transfer to the DB plan. At least 65 percent of the group needed to vote to switch for any switches to occur.[26]

In July 2008, West Virginia certified the results of a vote — 79 percent of teachers voted to switch to the DB plan. An overwhelming number of younger teachers — over 75 percent of those under the age of 40 — decided to make the same switch.[27] This result was a surprise, since it is often assumed (incorrectly, as it turns out) that younger workers prefer DC plans over DB plans.

Pensions and Fiscal Responsibility

Because public employers answer to the taxpayer, fiscal responsibility is of primary importance. Public retirement plans must be cost-effective and make efficient use of tax dollars. Because of their group nature, DB plans stretch each dollar further than DC plans, which are based on individual accounts. Due to the economies of scale that a group DB plan can achieve, the cost differential can be dramatic. A recent analysis showed that to provide a given level of retirement benefit, a typical DB plan could do the job at about half the cost of a DC plan.[28]

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Another fiscal consideration is the effectiveness of DB plans in achieving adequate retirement goals. After all, if a retirement plan does not fulfill its mandate — allowing employees to retire — it is not an effective use of taxpayer funds. A growing body of research indicates that employees with DB pension plans are better positioned to achieve a secure retirement than those in a DC plan alone.[29] And the experience of two states — Nebraska and West Virginia — suggest this is also true with respect to public sector workforces. Both states offered DC plans to some public employees but abandoned the programs when it was revealed that the benefits provided did not allow employees to retire with an adequate income.[30]

Considering how efficiently DB plans convert current contributions into future pension benefits, it is ironic that these plans have attached withering criticism by taxpayer organizations. Groups like the Howard Jarvis Taxpayer Association have been vocal critics of pensions. They were key supporters of Governor Schwarzenegger's efforts in 2005 to close the state's traditional pension plans to newly hired employees and offer individual retirement accounts instead. A consistent claim of taxpayer groups is that pension funds are creating unsustainable burdens for current and future taxpayers. Indeed, Governor Schwarzenegger in 2005 described the state's pension plans as "a looming train wreck."

But *The New York Times* reported that "even advocates of privatization in his own administration say the system is currently sound" with a ratio of assets to benefit obligations of about 90 percent.[31] In 2005, the initiative failed to garner support among California voters. But in light of the new economic circumstances, taxpayer groups may raise the issue anew.

Looking Ahead

Over the past three decades, private sector employers have become less likely to offer traditional defined benefit pensions, and have turned to defined contribution retirement savings accounts, like 401(k) plans. Three decades ago, DB pension coverage in the private sector was similar to that in the public sector. Today only about one-third of private sector employees with a retirement plan are covered by a DB plan.[32] This shift has had enormous consequences. According to Congressman George Miller, chairman of the House Education and Labor Committee, "The current economic crisis has exposed deep flaws in our nation's retirement system. For too many Americans, 401(k) plans have become little more than a high stakes crap shoot." This state of affairs has prompted a far-reaching re-evaluation of retirement policy at the national level.

The divergence in pension coverage in the private and public sectors has prompted some policymakers to explore whether to follow the private sector trend and recraft their retirement programs. In light of recent stock market losses

that have hit investors of all stripes, including public pension plans, more public employers may consider this question. States that have carefully investigated the matter have concluded that closing down their DB pension programs is the wrong direction for public policy.

First, abandoning DB plans would mean relinquishing demonstrated benefits on retention. Second, since public employees value these programs so highly, switching to DC programs for newly hired employees could harm recruitment efforts. And third, the cautionary examples of West Virginia and Nebraska indicate that public employers should "look before they leap." Redesigning retirement benefit plans might squander valuable taxpayer dollars on less-efficient programs that fail to meet their stated objectives.

Because DB pension plans have a track record of simultaneously meeting the goals of employers, employees, and taxpayers, they will continue to be a durable feature of compensation arrangements in the public sector. Current economic conditions notwithstanding, the impending retirement of the Baby Boom generation will force government employers to hire their replacements.[33] When the economy recovers, government entities will have to compete for talent with private sector employers — who may be able to offer higher salaries, stock options, or profit sharing programs — while meeting their fiscal responsibilities to make the most of taxpayer dollars.

The good news is that DB pension plans help to attract and retain skilled workers. The widely publicized trend away from these plans in the private sector may even help public sector employers compete more effectively by offering a unique benefit that is highly valued by skilled employees. ❋

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