

State Retirement Plans

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Topic Area: State Retirement Systems

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Introduction

When one thinks of state or public employment, generally the benefits associated with these positions come to mind. Historically, states have provided benefits, including retirement, to their employees. In recent years, however, more and more states are moving away from providing benefits through Defined Benefit Retirement plans, or pension plans, and are instead instituting mandatory Defined Contribution plans, more commonly called 401(k) plans. In the January 2006 issue of *Governing* magazine, Josh Goodman notes “Many states offered generous new retiree benefits to their employees in the 1990s or failed to invest adequately in their pension systems. Then, the economy weakened at the beginning of this decade, and the stock market turned more bearish as well. As a result, state pension systems took a sizable hit, and massive unfunded liabilities emerged” (Goodman, 2006). These unfunded liabilities are the primary reason that states are switching from Defined Benefit plans to Defined Contribution plans. Currently the states that offer only Defined Contribution plans to new employees are Alaska and Michigan, while Indiana and Oregon offer a combined plan with both defined benefit and defined contribution components (See Appendix I).

Reasons why States are Switching

There are many reasons why states are switching from Defined Benefit plans to Defined Contribution plans. While the unfunded liabilities experienced in several states have been cited as one cause, many states are looking to switch for a variety of reasons. Most of these reasons, however, are financial concerns of the state.

As previously stated, in the 1990s, following the drop in the stock market, many states began to realize unfunded liabilities in their pension plans. One such state was Alaska. Alaska currently has an unfunded pension liability of approximately 5.7 billion dollars. After learning of this, then-governor Frank Murkowski stated, “We have a constitutional duty to make sure every dollar of pension benefits are paid and so we had a responsibility to enact reform” (Drudge Forum, 2005). This reform came in the way of Senate Bill 141, which enacted the new defined contribution plan for employees hired after July 1, 2006. While the former defined benefit pension plans have been grandfathered for existing employees, all new employees hired after July 1, 2006 are only given the choice of being enrolled in the defined contribution plan now offered by the State.

A second reason that some states are switching to defined contribution plans is because of growing concern for their future financial position. In May of 2005, the Acting Governor of New Jersey, Richard Codey, created the Benefits Review Task Force to review and recommend changes to the state employee's benefit system because of a growing concern about the affordability of these benefits over the long term. The task force rejected the significant change of switching completely from a defined benefit plan to a defined contribution plan. Upon review of the information, the task force discovered that not only had monies earmarked for the pension system been allocated elsewhere by the State government, but that employees that would not be eligible under State policy for these benefits were receiving them. When these discrepancies were discovered, the task force recommended immediate reform of how the monies in the pension system were being utilized and who was receiving benefits. They also identified several changes be made to the system. These included: raising the age at which one could retire with full benefits from fifty-five to sixty, basing the pension on the average of the five highest salaries (as opposed to the current three) or on the highest three years to make the pension reflect a longer time horizon of an employee's salary (The State of New Jersey, 2005). New Jersey now offers the option of a defined contribution plan to new employees, but continues to operate its seven defined benefit pension plans as well. Employees have the option of participating in one or both plans simultaneously.

An additional problem plaguing some state retirement services is the individuals who have been placed on the boards of these institutions, both in terms of their education and training in investment decisions, and the ethics required of board members. Board members wield considerable power in making important investment decisions, yet in some states members lack formal training in investments or lack a background in fiduciary fields. Board members may include former public service employees, union-selected trustees, or individuals who hold political office. *Governing* magazine cites a survey taken of state systems addressing this problem. "Of the 25 [states] that responded, only nine had any formal education policy for board members, only six had mandatory educational requirements, and only one had a mandatory certification program" (Barrett & Greene, 2007, p.29). This is problematic, as investment decisions are complicated. The information that is presented, calculations used to determine projected investment returns, retiree life spans, and inflation rates are extremely complex, and being just one percentage off in these estimates can equate to hundreds of millions of dollars in a large pension plan. Not only are many of these board members lacking in the educational qualifications to administer a large pension plan, additional problems of unethical behavior have also been exhibited. Board members may have conflicts of interest such as only doing business with financial investment firms that contribute large sums of money to elected officials, or seeking kickbacks from investment firms for agreeing to do business with their organization (Barrett & Greene, 2007, p.30).

Another reason that some states are switching to defined contribution plans is that funding the pension plan and a health plan for retired employees has grown too costly with the rise in health care costs in the United States. In 1997, Michigan, in an effort to control future employer costs, passed legislation to change from a defined benefit plan to a defined contribution plan. Employees hired after March 31, 1997 were only given the option of participating in a defined contribution plan. Existing employees were given the option to stay with the defined benefit plan or switch to the defined contribution plan. An overwhelming majority (90%+) opted to stay

in the defined benefit plan (CalPERS, 2005). Michigan has historically and continues to provide health benefits to retired employees (U.S. Government Accountability Office, 2007). The cost of these services is cited as one reason Michigan sought to control costs in their benefit plans (Utah Retirement Systems, 2007a).

It is unlikely that Utah will move entirely from a defined benefit plan to a defined contribution plan because the reasons discussed above are not applicable to Utah. The amount of unfunded liabilities in the Utah State pension systems fluctuate from year to year, but are low compared with state averages that have resulted in a switch to a Defined Contribution plan (Utah Retirement Systems, 2006). Also, no information or research has shown that the State of Utah misappropriates in any way the money that is earmarked for their pension funds, or is offering benefits to ineligible individuals. The Comprehensive Annual Financial Report 2006 indicates that the money is being properly utilized and invested for the benefit of employees (Utah Retirement Systems, 2006). The State also currently has seven individuals serving on the board for Utah Retirement Systems, and four of the seven are distinguished as representing the “investment community.” This shows a desire by the State to have investment-savvy individuals making decisions regarding the pension plan. Finally, the State of Utah does not fund health care benefits for retired employees. This also keeps the costs of administering the defined benefit plans under control, as the funds are not being taxed in an effort to keep up with the rising costs of health care, as was a concern in Michigan (Utah Retirement Systems, 2007a).

Attitudes/Information Available from Utah Retirement Systems

The State of Utah is also unlikely to change completely over from a defined benefit (DB) plan to a defined contribution (DC) plan. The Utah State Retirement Systems website provides a pamphlet that analyzes the defined benefit versus the defined contribution plans and argues against phasing State retirement systems from DB to solely DC plans. The pamphlet lists several possible negative outcomes of switching from DB to DC plans and they are summarized as follows:

1. Switching to a DC plan and phasing out DB retirement benefits will require that wages increase in the public sector (because historically wages in the public sector have been lower than the private sector but retirement benefits have been higher), offsetting any savings the employer may have realized from shifting to a DC plan.
2. Public sector organizations may experience higher turnover because individuals may lose incentive to remain in their careers due to a desire to earn a 30 year retirement benefit and move to the private sector.
3. Introducing a DC only benefit will not eliminate the necessity of continued maintenance of the DB plan because the DB plan will need to be administered for current retirees and those with vested service.
4. The cost for the DB plan would climb if the plan is closed because there would be no new members entering the plan who may terminate prior to vesting, thus forfeiting their contributions and helping to fund those employees who remain in the plan.
5. If the DB plan is eliminated, public employees who do not have enough income at retirement to support themselves may turn increasingly to the welfare system to provide support.

6. DC only plans produce a smaller benefit at retirement than a DB plan.
7. Utah's retirement system has both a DB and a DC component which allows members to select among various options for investing while still being able to rely on stable retirement income from their DB plan.
8. Leakage, or loss of assets before retirement to loans and by cashing out retirement savings, is a key reason that DC plans are unreliable vehicles for ensuring retirement income security.
9. As a group, employees are generally poor investors and their investment decisions result in insufficient retirement savings.
10. DB plans assist employers in promoting orderly turnover and enable participants to qualify for a benefit on the basis of their age and service, whereas DC plans provide neither employers nor employees assurance of retirement eligibility when employees would normally retire.
11. The median cost of administering a DC plan is approximately 1.40% industry-wide, while the cost of administering a DB plan is approximately 0.30%.
12. A DB plan is a life-time annuity which a member cannot outlive, whereas a DC plan expires when the money runs out. In addition, a DB plan offers both a disability as well as line-of-duty death benefit which a DC plan does not.
13. Finally, timing is critical to the success of a DC plan because the retirement calculation depends on the circumstances of the market at retirement (Utah Retirement Systems, 2007b).

These ideas and attitudes, propagated on the Utah Retirement Systems website, do not show a move or a shift toward switching completely to a Defined Contribution Benefit plan. Instead, they show a preference toward keeping the current system of a Defined Benefit Plan, complemented by a Defined Contribution plan.

Bills Recently Introduced in the Utah State Legislature

A final indicator that shows that it is unlikely that the State of Utah will switch solely to a Defined Contribution Plan is the nature of the bills regarding retirement that have recently been introduced in the 2007 General Session of the Utah State Legislature. The following is a brief description of each of these bills, along with some additional commentary regarding their status:

2007 Bills Introduced by the State Legislature

H.B. 0012, entitled: "Additional State Retirement Benefit" proposes to modify the Utah State Retirement and Insurance Benefit Act by authorizing additional retirement benefit for certain retirees. This includes increasing the retirement allowance of members of the Public Employees' Contributory Retirement System with service prior to July 1, 1975; and increases the retirement allowance of members of the Public Employees' Noncontributory Retirement System with service prior to July 1, 1975.

Outcome/Comments: House Bill 0012 introduced in the 2007 General Session of the legislature is a re-introduction of H.B. 58 that was introduced in the 2006 General Session of the legislature. While both bills were placed in the House file for defeated bills, these measures show favorable attitudes toward retirement benefits for State employees.

H.B. 0198, entitled “Public Safety Retirement” proposes to modify the Utah State Retirement and Insurance Benefit Act by increasing the cost-of-living and certain death benefit allowances for members of the Public Safety Retirement Systems. This bill would increase the cost-of-living allowance for members of the Public Safety Contributory Retirement System; increase the cost-of-living allowance for members of the Public Safety Noncontributory Retirement System; increase the allowance payable to the surviving spouse of a retiree of the Public Safety Contributory Retirement System; provide a portion of the tax on property insurance and life insurance to fund the increase in the public safety cost-of-living allowance and surviving spouse benefit; and repeals the Public Safety Retirees’ Cost-of-Living Increase Restricted Account and provides intent language that remaining monies in that account shall lapse into the General Fund.

Outcome/Comments: This bill also shows favorable attitudes toward increasing retirement benefits for State employees. The bill, however, was placed in the House file for defeated bills.

H.B. 0325, entitled “Public Employees 25 Year Retirement” proposes to modify the Utah State Retirement and Insurance Benefit Act by decreasing the years of service required to qualify for an unreduced retirement allowance for members of the Public Employees’ Noncontributory Retirement System. This would decrease the years of service required to qualify for an unreduced retirement allowance from 30 to 25 for members of the Public Employees’ Noncontributory Retirement System; and makes technical corrections.

Outcomes/Comments: House Bill 0325 introduced in the 2007 General Session of the legislature is a re-introduction of H.B. 0320, introduced in the 2006 General Session of the legislature. While both bills were placed in the House file for defeated bills, these measures show favorable attitudes toward retirement benefits for State employees.

H.B. 0377, entitled “Retirement Benefit Amendments” when introduced proposed to modify the Utah State Retirement and Insurance Benefit Act to provide for an optional defined contribution retirement plan. This bill would define “defined benefit”; allow new employees hired beginning July 1, 2007 who are eligible to earn service credit under any State retirement system to make a one-time election to: become a member of a defined benefit retirement system for which the employee is eligible; or receive a defined contribution in lieu of a defined benefit; allow current employees who are eligible to earn service credit under any State retirement system to make a one-time election to: stay a member of a defined benefit retirement system; or receive a defined contribution in lieu of a defined benefit; provide that earned service credit and contributions in a defined benefit system remain in the system until the person retires; provide that, subject to federal limitations, the defined contribution amount is at least the same percentage of salary that is being contributed for similar employees in a defined benefit system including any supplemental contributions; provide a minimum defined contribution amount; provide that the defined contribution amount for a governor or a legislator is the same percentage of the governor’s or legislator’s salary that is provided to an active member of the Public Employees’ Noncontributory Retirement System; and make technical changes.

Outcomes/Comments: The House eventually substituted a bill for this one—one that looked nothing like this original bill. The original bill obviously showed a desire to move away from DB plans toward DC plans, by allowing employees to opt out of the DB plans to exclusively contribute to the DC plans. While this bill specifically had to do with DB and DC plans, the substituted bill dealt this allowing technology employees to opt out of retirement

benefits if they so chose. Eventually the substitution bill was placed in the House file for defeated bills (Utah State Legislature, 2007a).

Note: During the November 13, 2007 Retirement and Independent Entities Interim Committee meeting, the idea behind the original H.B. 377 was presented to the committee for consideration. It was stated that this was done for information purposes only, not necessarily to adopt the bill from committee. When this information was presented, the following concerns were expressed by the Senators and Representatives populating the committee. They included: cost concerns of making the change, concern for people making poor investment choices being hurt in their retirement, a raise in the turnover rate of State employees, and concern that this could progress from a choice to a mandate. It was unclear if this bill would be re-introduced to the committee in the future for consideration in the 2008 General session (Utah State Legislature, 2007b).

H.B. 0387, entitled “Post-Retirement Benefits Restrictions” proposes to modify the Utah State Retirement and Insurance Benefit Act by amending reemployment restrictions for certain retirees. This bill provides that employees that are reemployed prior to April 30, 2007 by a participating employer may be given a defined contribution at the same percentage of a retiree’s salary that the participating employer would have been required to contribute if the retiree were an active member; requires a participating employer that hires a retiree beginning April 30, 2007, to contribute 1.5 percent of the retiree’s salary to a retiree designated defined contribution plan; prohibits a participating employer from providing health care coverage to the retiree or the retiree’s dependents during any period that the retiree is the primary covered individual of a post-retirement health insurance plan; provides for certain exceptions; and makes technical changes.

Outcomes/Comments: This bill also shows a desire to restrict benefits of employees that are re-employed. The bill, however, was placed in the House file for defeated bills.

S.B. 0039, entitled “Public Safety Retirement Death Benefit Modifications” proposes to raise the cap on the death benefits of retired members of the public safety retirement systems. This bill raises the cap on the death benefits of retired members of the Public Safety Contributory Retirement System; and raises the cap on the death benefits of retired members of the Public Safety Noncontributory Retirement System.

Outcomes/Comments: This bill also shows favorable attitudes toward raising the cap on the death benefits of retired members of the public safety retirement systems. The bill, however, was placed in the House file for defeated bills (Utah State Legislature, 2007a).

These bills show that there is a desire within the Utah State Legislature toward increasing the retirement benefits received by State employees, not to reduce them. This attitude is not parallel with the attitudes of many states prior to switching benefits from a Defined Benefit to a Defined Contribution plan. Prior to changing their retirement benefits, most states have also commissioned task forces or committee groups to review alternatives in their retirement funding options. The State of Utah has not yet done this, further indicating that there are no plans in the near future to consider such a drastic change.

Summary

From information gathered from other states, the Utah Retirement Systems website, and the bills that were introduced into the 2007 General Session, it is unlikely that the State of Utah will change its retirement benefits for State employees in the near or distant future. The State is not experiencing some of the same financial concerns that other states have experienced (example: Alaska and their unfunded liabilities and Michigan and their healthcare costs). During the October 17, 2007 Government Operations Interim Committee meeting, the Department of Human Resources for the State of Utah announced that the State was receiving an extremely high rate of return on investment in their Defined Benefit and Defined Contribution plans (Utah State Legislature, 2007c). The State of Utah currently offers a defined contribution benefit plan as an additional retirement savings vehicle for its employees.

There are significant implications associated with changing from a Defined Benefit Pension plan to a Defined Contribution plan. One of the draws that brings people into state employment, in spite of lower wages than the private sector, is the superior benefits package. If the State were to switch from the DB plan to a sole DC plan, which would diminish the benefits package, the State would need to make up the deficit in some way to remain competitive for employees with the public sector (Utah Retirement Systems, 2007b). Also, because the State of Utah offers a hybrid plan—meaning that employees can contribute to a Defined Contribution plan in addition to the Defined Benefit plan, then employees have the choice of taking that DC plan with them if they leave State service. If they choose to stay in State service, however, the DB plan is available for them.

It has been shown that DB plans garner a higher return on investment overall than do DC plans. Another implication of the State switching completely from a DB plan to a DC plan would be that at retirement, former State employees may not have enough money to support themselves, and may have to turn to the State welfare system to supplement their income. This would obviously cost the State money to support long-term.

These implications have been expressed as concerns by Utah Retirement Systems regarding switching completely over to a DC plan (Utah Retirement Systems, 2007b).

Appendix I

Types of Pension Plans in Place for Newly Hired General State Employees, as of 2007 (U.S. Government Accountability Office, 2007).

State	Type of Pension Plan
Alabama	Traditional Defined Benefit
Alaska	Defined Contribution
Arizona	Traditional Defined Benefit
Arkansas	Traditional Defined Benefit
California	Traditional Defined Benefit
Colorado	Traditional Defined Benefit
Connecticut	Traditional Defined Benefit
Delaware	Traditional Defined Benefit
Florida	Traditional Defined Benefit
Georgia	Traditional Defined Benefit
Hawaii	Traditional Defined Benefit
Idaho	Traditional Defined Benefit
Illinois	Traditional Defined Benefit
Indiana	Combined (with both definite benefit and defined contribution components)
Iowa	Traditional Defined Benefit
Kansas	Traditional Defined Benefit
Kentucky	Traditional Defined Benefit
Louisiana	Traditional Defined Benefit
Maine	Traditional Defined Benefit
Maryland	Traditional Defined Benefit
Massachusetts	Traditional Defined Benefit
Michigan	Defined Contribution
Minnesota	Traditional Defined Benefit
Mississippi	Traditional Defined Benefit
Missouri	Traditional Defined Benefit
Montana	Traditional Defined Benefit
Nebraska	Cash balance defined benefit
Nevada	Traditional Defined Benefit
New Hampshire	Traditional Defined Benefit
New Jersey	Traditional Defined Benefit
New Mexico	Traditional Defined Benefit
New York	Traditional Defined Benefit
North Carolina	Traditional Defined Benefit
North Dakota	Traditional Defined Benefit
Ohio	Traditional Defined Benefit
Oklahoma	Traditional Defined Benefit
Oregon	Combined (with both definite benefit and defined contribution components)
Pennsylvania	Traditional Defined Benefit

Rhode Island	Traditional Defined Benefit
South Carolina	Traditional Defined Benefit
South Dakota	Traditional Defined Benefit
Tennessee	Traditional Defined Benefit
Texas	Traditional Defined Benefit
Utah	Traditional Defined Benefit
Vermont	Traditional Defined Benefit
Virginia	Traditional Defined Benefit
Washington	Traditional Defined Benefit
West Virginia	Traditional Defined Benefit
Wisconsin	Traditional Defined Benefit
Wyoming	Traditional Defined Benefit

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