Our Strong Suit is Knowledge

In 2001 the National Conference of Public Employee Retirement Systems (NCPERS) produced a booklet on the evolution of Public Pension Plans entitled "The Evolution of Public Pension Plans Past, Present and Future."

One of our strong suits in protecting our pensions and benefits is knowledge. Not only knowledge of current issues, but also knowledge of the history and evolution of each and every issue, and how the outcome of issues may impact our future.

In the remainder of this article I will be sharing direct quote excerpts from the latest NCPERS Evolution Booklet.

This document presents an overview of how pension plans in the public sector have evolved. For most of the last century public plans were defined benefit (DB) plans, considered by the majority of public sector employees to be the most valuable benefit received during a long career in public service.

Over the last decade, however, public sector DB plans have increasingly come under attack. In an effort to cut costs, due in part to global competition, many corporations have frozen or terminated their DB plans and replaced them with defined contribution (DC) plans. Some public officials have applied similar logic to state and local governments, and have sought to replace public sector DB plans with DC plans. Although the results of this change would likely have significantly negative consequences for taxpayers and public employees, as pointed out in the NCPERS research report "The Top Ten Advantages of Maintaining Defined Benefit Pensions:' these efforts have been successful in a few states and municipalities.

However, demographic and economic pressures have led some public DB plans to reexamine their plan designs, and consider blending DB and DC plan features. For example, the median age of the public sector workforce is about 45, meaning half of current public employee will likely retire in the next 15 to 20 years. To replace them, state and local governments will need to provide benefits that are attractive to younger, more mobile workers. DB plans, designed more for long-term employees, have lacked the portability that younger workers desire.

In addition, the stock market volatility over the past decade has increased the awareness of public employers and employees regarding the potential risks and rewards of the financial markets. While the markets are up, as during the late 1990s, there was growing pressure on the part of employees to participate in DC plans. However, when the stock market declined from 2000 through 2002, many workers saw the value of their DC accounts decline by 50% or more, causing many to reevaluate the attractiveness of DC plans. The stock market decline also increased DB plan costs, causing the governmental plan sponsors to look for ways of more equitably sharing market risks.

Public sector retirement plans for state and local government employees date back over a century to the late 1800s. These plans were developed by government employers to provide retirement benefits for employees who were in public service. In many cases the plans were offered to make public employment competitive with employment in the private sector, which often paid higher wages. The reasoning was that although an employee earned less money working for a government, their retirement benefits were guaranteed. This guarantee protected employees and family members throughout their retirement years.

Defined Benefit Plans: DB plans provide employees with retirement benefits using a predetermined formula, typically based on the participant's salary and years of service at retirement. Although formulas vary widely, a fairly typical retirement benefit is 2% of final average salary times years of service, with salary averaged over the last three to five years of service. Under this formula, the annual benefit for an employee who retired after 20 years of service with a final average salary of $50,000 would be $20,000 (i.e., 2% x $50,000 x 20 years). Employees can, therefore, predict their retirement benefit by approximating how long they intend to work and what they estimate their salary will be at retirement.

Defined Contribution Plans: DC plans provide benefits through individual accounts established for each employee. In DC plans, the employer contribution made on behalf of each participant is defined, or stipulated, in the plan. Often employees contribute as well, either on a mandatory or voluntary basis (or both). Typically, the accounts are managed by an independent, third-party administrator; and employees direct how their accounts are invested among a variety of funds. Federal income taxes on contributions and investment earnings are deferred until the funds are distributed to the employee.

Ultimately, the individual's retirement benefit is determined by accumulated contributions and investment income, less investment management fees and operating expenses. At retirement, the benefit may be paid in a lump sum (the most common form of distribution) or as an annuity or as a combination of the two, as permitted by plan design or current tax law. Once the employee retires or otherwise leaves employment, the employer is no longer responsible for contributing to or otherwise providing the benefit.

Hybrid Plans: Hybrid plans combine DB and DC plan features. While a change from a pure DB plan shifts a portion of the risks (and potential rewards) to employees, the hybrid approach typically provides a tax-advantaged means for employees to contribute towards their retirement and to invest in diversified funds. In addition, when used in the public sector, the hybrid approach typically allows employees to convert their DC accounts to an annuity, which adds to the employees' lifetime benefits.

Innovative Plan Designs: As noted in Chapter 1, many state and local retirement plans were originally established to provide retirement benefits in two parts: (1) a lifetime benefit provided by the employer based on the participant's salary and length of service; and (2) an annuity benefit based on accumulated employee contributions and investment returns.

Over time, the complexities involved in administering the separate plans and, in many cases, managing employee contribution rates based on age and gender, prompted plans to simplify their designs and led to broad application of the DB plan approach. By the late 1970s, most public plans were DB plans. Although employee contributions were still required for the majority of public plans, the benefit promised did not depend on accumulated employee contributions.

More recently, however, the demographic, economic, and political pressures discussed in Chapter 3 have led some state and local governments to consider alternatives to the DB approach. While a few governments have switched to DC plans, more governments have been reluctant to shift completely away from DB plans, and have combined DB and DC plan features. To illustrate the various hybrid plans provided by governments, the remainder of this chapter presents five short case studies, each describing a hybrid approach:

> [Editor's note: the five plans included the Municipal Employees' Retirement System of Michigan, The Texas Municipal Retirement System, The Ohio Public Employees Retirement System, The Washington State Teachers' Retirement System, and the Colorado Public Employees' Retirement Association]

It is always rewarding to see that our Ohio PERS, is named among the innovators, and I believe we should be proud that we have been an integral part in working with our pension plan administrators and members of the Ohio General Assembly to recognize our retirement system as one of the major innovators of staying current with the times.