RESEARCH BRIEF
The Public Affairs Research Council of Louisiana
April 2012

Governor's Cash-Balance Plan Offers Advantages But Questions Remain About Its Ultimate Impact

INTRODUCTION

The governor is proposing a set of changes to Louisiana's pension programs for the purpose of reducing the state's retirement costs and the burden of pension liabilities. Among these initiatives is a proposal to offer a cash-balance plan for new hires that over time would replace the existing defined benefit plan as the primary retirement program for most state workers. This report examines the state's unfunded accrued liability and the potential impacts of the cash-balance plan on the state and its employees.

The proposed cash-balance plan would replace the existing defined benefit plan as the primary retirement program for new state workers.

Most Louisiana government workers and teachers are enrolled in a defined benefit plan, in which employees receive a guaranteed monthly income for the rest of their lives after they retire. The income is based on a formula that includes the number of an employee's years of service and the average salary of the employee's highest-earning years, which are usually the last few years before retirement. The formula -- not the performance of the retirement system investment portfolio -- determines the guaranteed benefits.

Traditional defined benefit plans can be attractive to long-term employees and are considered by many to be an effective recruitment tool for government service. But taxpayers are at great risk if the plans are not properly financed, if financial markets drop, if inflation soars, if actuarial estimates are inaccurate or if retirees earn more or live longer than expected. And the earlier a plan allows full retirement eligibility, the more expensive a traditional defined benefit plan is to maintain.

For taxpayers, the governor's proposed cash-balance retirement plan aimed at new state employees potentially brings several distinct advantages over Louisiana's current defined benefit system. The main benefit could come in the form of long-term cost savings from guaranteeing only the interest gained on employee retirement accounts. The state would not be promising a greater benefit than the gains achieved in the financial markets, thereby reducing the risk of accumulating unfunded liabilities. However, under a cash-balance plan, employees are protected in that their retirement accounts cannot lose value. This protection runs a financial risk for the retirement systems. Actuarial estimates vary as to whether the plan would offer cost savings to the state.

The cash-balance plan would not use the current system's "final pay" formula, which leads to salary spiking and other bad effects. For some employees who do not spend their full careers in government service, the cash-balance plan offers the advantages of portability and under some scenarios provides a better financial package.

Actuarial estimates vary as to whether the plan would offer cost savings to the state.

Decision makers should design the program to provide employees a fair level of retirement benefits based on realistic expectations, especially considering the fact that Louisiana's state government workers are not participating in the federal Social Security program and therefore lack that financial cushion in their later years. The Legislature so far has not focused on forming a consensus about what a fair level of benefits should be. Other states that have debated pension reform have made this topic a priority. Also, the version of the cash-balance plan passed by the House Retirement Committee contained very minimal compensation for survivor and disability benefits.

The state should be considering options for a new retirement system for new employees. If a new system is adopted, it should be designed in a way that encourages full funding, diminishes the prospect of unfunded liabilities and offers taxpayers some protections against the negative impacts of poor financial markets and overly optimistic investment projections.

Proponents of a new plan should demonstrate that it would be cost-effective compared to the current plan: if retirement benefits for long-term workers are going to be lower under a cash-balance program, which appears to be the likely scenario, then the state's long-term expense of financing the plan should be lower also. Conflicting actuarial reports on the cash-balance initiative have painted an unclear picture of whether this goal can be achieved.

Policymakers should examine carefully those elements of the cash-balance initiative that might lead to understated risks and liabilities for the state. Ultimately, the impact of the cash-balance plan will depend on what takes place in the future with regard to investments and other unknown factors, and so the anticipated advantages of adopting the plan will vary depending on assumptions about those future events. Under most sets of assumptions, the cash-balance plan carries less risk than the current system of inflating the unfunded liabilities in the retirement systems.

> The cash balance plan would not use the current system's "final pay" formula, which leads to salary spiking and other bad effects.

THE CURRENT SITUATION

The state's four retirement systems collect money from the paychecks of currently covered employees and from the state agencies that employ them. The two largest state retirement systems are the Louisiana State Employees' Retirement System (LASERS), which covers about 54,000 mostly rank-and-file state employees, and the Teachers' Retirement System of Louisiana (TRSL), which covers about 83,000 personnel, including public school teachers and college faculty.

Each of the retirement systems manages its own investment portfolio, which finances the payment of retiree benefits. Gains and losses for the investments can make a big difference in whether the accounts have enough money ultimately to support the required retirement payments. A projected shortage means there is an unfunded accrued liability (UAL), which is an estimate of how much money the systems need, in addition to current assets, to pay for all future benefits.

> Proponents of a new plan should demonstrate that it would be cost-effective compared to the current plan.

Among the states, Louisiana has one of the poorest ratios of liabilities versus assets in its retirement systems; it has less than 60 percent of the assets needed to cover long-term liabilities. The combined unfunded liability of the four state systems is $18.9 billion. This figure could get better or worse in the future, depending on the boom or bust of the investment accounts, the amount the state pays toward reducing the debt and whether the systems are accurately predicting future salaries, lifespans and other actuarial factors. Changes in retirement law also could affect the UAL. For example, a higher retirement age would reduce a system's ultimate liabilities for benefit payments.

The state does not have to pay off the unfunded liability immediately but must make large payments toward it. For the next fiscal year, if no changes are made to the law, the state will pay $1.28 billion toward unfunded liabilities. To put this figure in context, this is nearly as much as the state expects to receive in corporate and business taxes and is about half the amount of the state's sales tax revenue. The figure well exceeds the state's general fund appropriation for all state colleges and universities. That debt payment plus the regular expense next year to sustain the state retirement programs will amount to about $2 billion, out of a total state budget of about $25.2 billion.

A CLOSER EXAMINATION

A deeper look at the history and future of these numbers and how they are affecting state costs will provide lessons for where the state should go next regarding its retirement plans.

Twenty-five years ago, the state passed a constitutional amendment requiring that its package of retirement debt up to mid-1988 be paid off by 2029. This led to an amortized schedule of payments for that debt, known as the Initial Unfunded Accrued Liability. Decisions made about this payment schedule had huge consequences for the next generation of taxpayers. Payments started out low and were to increase over time. The state chose an amortization method that arranged for payments in the early years that were less than the interest charged on the outstanding balance. So the debt was allowed to grow even larger. All the state's payments on the schedule have been made, but the heavier costs were shifted to the future.

Since 1988, a new Unfunded Accrued Liability has taken shape. The delayed amortization of the Initial UAL and other increasing payment schedules has added $4.9 billion to the unfunded liabilities of the LASERS and Teachers systems. State investment losses, particularly during the recession and financial markets disruption that began in 2008, made matters worse, adding $5.2 billion to the UAL of the two systems. Cost of living increases for retirees added another $2.4 billion. Revised actuarial calculations of future liabilities for the two systems -- based on changing predictions about the number of employees, salaries and death rates – added about $400 million.

RISING PENSION COSTS FOR THE STATE

State agencies, which are public sector employers, make payments to address these unfunded liabilities as part of their personnel costs. As a percentage of payroll, state employers this year were slated to contribute 8.6 percent toward paying off the Initial UAL and 10.4 percent to the new UAL, according to the Legislative Auditor. Retirement system officials dispute those figures and say the Initial UAL poses the greater financial burden. Whatever the case, the newer debt is clearly part of the problem.

Separate from the UAL payments, contributions must also be made toward the cost of retirement benefits earned by current government employees during the work year. This is known as the normal cost and it changes year to year, typically falling between 12 percent and 16 percent of payroll. Employees by law pay a set amount to the normal cost, with most workers in LASERS contributing 7.5 percent or 8 percent of their pay. The state employer contribution for the normal cost is determined by actuaries and varies each year. The employer normal cost is usually from 5 percent to 7 percent, although next year it will be closer to 8 percent.

Louisiana's retirement systems have less than 60 percent of the assets needed to cover long-term liabilities.

The total expense to agencies to cover both the normal costs and the unfunded liability payments for employees in LASERS next year will be about 28 percent, unless the law or other conditions change.

Because of the back-loaded schedule for paying off the unfunded retirement liabilities, rising payments are coming due annually. As a Legislative Auditor report observed, "The retirement systems are now approaching the steep portion of the slope of scheduled payments." According to the current schedule, the state will pay more every year until 2029. Next year's total UAL bill will be $1.28 billion, the next year $1.38 billion, the next $1.45 billion and so on until 2029, when the bill will be $1.75 billion. By 2030, the Initial UAL will be gone and the subsequent annual payments toward the remaining UAL will be about $1 billion. That, of course, assumes the state properly funds and meets its actuarial assumptions, most importantly its investment return. Otherwise, the state could accumulate more unfunded liabilities.

EXPENSIVE RETIREMENT PROGRAMS

This schedule of payments is not likely to bankrupt the state but it eats substantially into other priorities, such as education, health care, public safety and social services. The state's revenue sources might be expected to increase enough annually to keep up with the rising retirement payments, but these other government programs will also be looking for those extra tax dollars.

Previous faulty projections about the ultimate cost of the state's unfunded liabilities have shaken many people's confidence that even the current dire outlook is either accurate or sufficiently pessimistic. Repeated assurances over the years that the state's costs were under control have proven to be untrustworthy. Fourteen years ago, the schedule of UAL payments for the LASERS and Teachers plans showed the state would pay $662 million in 2013; the updated current schedule shows almost twice that amount due in 2013. In that span of time the United States weathered a technology stocks crash, the Sept. 11 terrorist attacks, major overseas conflicts, a financial and real estate markets crash, a deep recession and the European debt crisis. Miscalculations about the future and world events have contributed significantly to unfunded pension liabilities across the nation.

The state next year is scheduled to pay 28 percent of payroll of LASERS employees to cover both the normal costs and the unfunded liabilities.

To avoid repeating this pension history, Louisiana leaders should create a retirement plan for new employees that guards against delaying payments toward a fully funded system and reduces the risk that actuarial miscalculations cause new unfunded liabilities. In addition, a sustainable system should limit the risk of the state's financial obligation to depressed investment and interest-rate markets as well as limit unfunded liabilities resulting from cost-of-living adjustments.

KEY POINTS ABOUT CHANGE

Two important considerations should be noted about the impact of launching a new retirement plan for new employees: the effect on the unfunded liabilities and Social Security.

If the state were to adopt the proposed cash-balance plan for new employees or even a 401(k) defined contribution plan of the type common in the private sector, the burden of the state's unfunded liabilities up to this point would not be reduced. Indeed, the value of a whole new retirement program for new employees cannot be measured by its impact on past debt. It should be measured as a comparison to the state's existing defined benefit plan as to whether it is less likely to generate a UAL of its own. Ideally, a new retirement system would be less volatile and more pragmatic from the taxpayer point of view while also being fair and offering greater flexibility to new employees.

A new retirement plan should take into consideration that Louisiana state government workers, unlike the vast majority of working Americans, are not eligible for Social Security. Neither they nor their agency employers make payroll deductions for Social Security, and this federal safety net of income is not available to them upon retirement. Also, the disability and survivor benefits available to Social Security enrollees are unavailable to Louisiana state workers.

This situation would create a real risk for workers if the state were to adopt a 401(k)-style defined contribution plan as the only retirement option for new state employees. A typical defined contribution plan stipulates how much an employer and employee may contribute regularly to a worker's investment account. Because there is no employer obligation and no pension fund to pay a future benefit, the employer's contributions are a predictable annual cost. No unfunded liabilities occur.

Although the state and its taxpayers would be at a minimal financial risk if government employees were placed in a defined contribution plan, such a retirement package would portend serious financial problems for those who retire during a bad investment market without Social Security benefits. Most workers in the private sector who have a defined contribution plan also have Social Security as an income foundation in retirement. Utah famously created a defined contribution plan option but that state's plan may not be the best model for Louisiana because Utah government workers also get Social Security.

Why not remove the state's exemption and place new employees in Social Security? The problem with that option is that the Social Security system itself has unfunded liabilities. Anyone participating in the federal program will be paying not only to support the normal costs but also the unfunded liabilities of the system. If state agencies and employees start paying into the Social Security program, they probably will not be getting the bang for the buck they could get by investing in a freshly minted retirement plan. For this reason, many pension analysts advise that if a state or local government is outside of Social Security, it should remain outside.

THE GOVERNORS'S CASH BALANCE PLAN: HOW IT WOULD WORK

The governor has proposed a cash-balance plan for new employees in LASERS and for new higher-education employees under the Teachers system. Other members of the two systems and members of the Louisiana School Employees Retirement System may elect to participate in the cash-balance program. Teachers in K-12 public schools are not required to join.

The proposed cash-balance plan is a type of defined benefit plan but with the significant difference that the retiree benefit is based on the accumulated wealth in the retirement account rather than being based on the employee's final average pay. Each employee would get an annual 12 percent pay credit toward a retirement account. The employee would contribute 8 percent of pay to the retirement system and the state would cover the remaining 4 percent.

A sustainable system should limit the risk of depressed investment markets and unfunded liabilities resulting from cost-of-living increases.

The employee account also would receive an annual interest credit equal to the system's actuarial return on assets, with 1 percent chipped off positive returns to buffer against the years when there might be a negative return. For example, if the annual rate of return on investments is actuarially determined at 6 percent, the employee's account would receive an interest credit of 5 percent. The actuarial rate of return is an estimated figure used by pension managers that is not the same as the actual gain or loss of investments.

If the system account grows with investment earnings, the employee's retirement nest egg grows also. The state would ensure that, even in a bad investment market when the real rate of return falls below zero, the employee's benefit account would not lose value. The account balance can increase with market gains but will not decrease with market losses. So the cash-balance plan is designed to provide a guaranteed benefit that would provide more than the monthly income from Social Security while also offering the potential for a more lucrative benefit in a favorable investment market.

The employee and state retirement contributions would be pooled with the state retirement systems' existing investment portfolios. The investments would be managed by the retirement systems, as they are now for the defined benefit plans.

A new retirement plan should take into consideration that Louisiana state government workers are not eligible for Social Security.

An employee would be vested after five years and the benefits would be portable. The vested employee could leave government service any time and take the value of the account balance, presumably by moving it tax-free into a private retirement investment plan. The current defined benefit plan does not offer this option. Under the existing system, a government employee who leaves before retirement must wait until retirement age to get the benefit or else can only get a refund on his past contributions.

At retirement under the cash-balance plan, the employee account could be converted into an annuity that would provide a regular income for life for the retiree and spouse. The annuity would be based on how much the employee is credited in the account, not on the worker's years of service and final years of salary. Starting at age 60, the employee could ask the state to convert the cash-balance account into an annuity at no cost. Otherwise, there is no retirement age attached to the cash-balance plan. The longer an employee works, the larger the account and the better the annuity. Employees would have several options, including a lower annuity with built-in cost-of-living adjustments over time.

Employees also could take a lump sum and move it into a private investment account. These options could provide some financial advantages that an annuity cannot, such as a nest egg that could be passed on to others upon death. But the lump sum option also poses risks for retirees who could live long enough to exhaust their investment portfolio. The lump sum option would be precarious, particularly in a state without Social Security for state workers.

THE IMPACT ON INVESTMENT RISK AND UNFUNDED LIABILITIES

In the governor's plan, the state would be less vulnerable to investment market volatility, although not totally immune. The governor's actuary, Buck Consultants, estimates that the cash-balance plan would reduce retirement system volatility for coverage of new members by about 40 percent over 30 years. The plan would somewhat reflect actual investment market conditions when figuring the upside of benefits while also providing a secure floor of guaranteed benefits to state employees. The opportunity for unfunded liabilities would exist, but less so than with a defined benefit program.

The interest credit would match the system's actuarial rate of return on investments "after smoothing." For example, investment losses in a single year would not have to be compensated by the state immediately; an adjustment would be made to spread the negative return over several years. By using an actuarial rate of return and smoothing, the benefit structure of the proposed cash-balance plan would not precisely match the investment system's real gains or losses each year.

The governor's actuary forecasts that, under most market conditions, the cash-balance plan would tend to reduce the state's unfunded accrued liability compared with a continuation of the current defined benefit plan. The actuary presented a range of models under different market conditions, with most assumptions resulting in UAL reductions.

The Legislative Auditor's actuary did not provide a set of forecast models or estimates of the cash-balance plan's effect on unfunded accrued liabilities. He did foresee that the cash-balance plan would be more stabilizing. The Auditor's actuary compared the state's risk to the employees' risk with regard to market conditions. In that context, he determined that the state would bear the same or even possibly a greater investment risk under the cash-balance plan because of the state's guarantee that employee retirement accounts would not lose value.

What would happen if the retirement systems experienced unusually high investment returns? Under a traditional defined benefit plan, the bonus mainly helps the state, because the gains would offset periods of losses and help reduce unfunded liabilities. The employees are really no better or worse off, because their retirement income is not based on market performance. Under the cash balance plan, the high returns would mainly help the employees, whose pay credit accounts would be boosted. The retirement systems would not be able to exploit the investment bonanza to offset periods of losses. This may be seen by some as a flaw in the governor's plan, which might be addressed by changing the employee's annual interest credit under certain conditions. For example, if a period of large investment losses were followed by a period of exceptionally large investment gains, the employee's annual interest credit could be set at something lower than 1 percent below the actuarial return on assets in the peak market years.

At retirement, an employee cash-balance account can be converted into an annuity providing monthly income for life.

THE IMPACT ON REGULAR ANNUAL STATE COSTS FOR RETIREMENT

How much would the state have to pay to maintain the normal costs of the cash balance plan? Each year the employee's retirement account would receive an annual pay credit of 12 percent of salary, with the employee contributing 8 percent of his or her pay. An employee account would not be an individual portfolio but would be a calculation of how much, eventually, can be withdrawn from the system account.

This is an important point in figuring how much the state agencies would actually have to pay each year to cover their 4 percent share of the pay credit. An agency's target amount to fulfill the pay credit would not necessarily be a cash contribution equal to 4 percent of payroll but in fact would be an amount based on a formula designed to keep the plan solvent. Because the annual interest credit to the employee account would be 1 percent below the anticipated rate of return on assets, the 4 percent share that the state would owe toward the account balance at the time of withdrawal may be financed with a contribution of less than 4 percent of pay. In other words, the state might not have to pony up the full 4 percent per year as a cash contribution in order to maintain the regular annual 12 percent pay credit.

Or, it might have to pay more. Using actuarial models in a 30-year projection, the Legislative Auditor's analysis determined that the normal cost for the cash-balance plan would exceed 12 percent of pay, causing the state to make up the difference. This conclusion was based in part on projections of overall strong rates of interest credits over time, which may or may not happen.

How would this compare with the current defined benefit plan? The Auditor's report said the normal cost for the current defined benefit plan is expected to be about 12 percent of pay. That's less than the current average normal cost for LASERS or Teachers employees because the Auditor is only counting new or relatively new employees, whose retirement terms are less generous than those for workers who were hired before changes in retirement law took effect in 2006 and 2011. For a fair comparison, the cash balance plan must be weighed against the current defined benefit plan as it applies to new employees.

The governor's actuary and the Legislative Auditor's actuary reached different conclusions about the costs of the cash-balance plan.

In doing so, the Auditor's analysis also concluded that the projected normal cost under the cash balance plan would exceed the normal costs of the defined benefit plan. As a means of financial stabilization, the cash-balance plan would do its job, but as a means toward a huge cost savings, it would not perform, the Auditor's actuary concluded.

The governor's actuary provided a range of projections under various market conditions and reached the opposite conclusion on costs. For example, over the next 20 years under the cash-balance plan, the accumulated savings in the state's contributions would be between $700 million and $2.2 billion, according to the governor's analysis.

The cash-balance plan would be portable, which could lead to higher turnover.

The differences between the governor's and the Legislative Auditor's conclusions are alarming. The opinions on costs are so substantially opposed that a third opinion may be warranted.

A SIGNIFICANT CHANGE FROM THE "FINAL PAY PLAN"

Under the cash-balance plan, retirement benefits would be based on accumulated investments, not on the top three or five years of earnings as in the current defined benefit plan. This has several positive implications, although critics point to a series of potentially problematic events.

Louisiana's current defined benefit system provides a guaranteed monthly benefit for the lifetime of a retiree. Under LASERS, this benefit is figured partly on the basis of the employee's highest successive 36 months or 60 months of earnings. This peak pay period tends to be at the very end of an individual's government career and so a system of this type is called a final pay plan. The Center for Retirement Research at Boston College states in an analysis of final pay plans that they "lead to undesirable effects on the relationship between total compensation and gross salary, distribute benefits across workers in a capricious fashion, provide little for employees who leave early, and create an incentive for earnings manipulation and expensive late-career promotions."

Calculating benefits on short periods of earnings, rather than basing benefits on lifetime earnings or accumulated retirement contributions, has several unfortunate effects. Most of the benefits in final pay plans are earned in the last few years of employment, which rewards long-term service and penalizes those who prefer less than a lifetime career in government. The Center for Retirement Research provides an example of a typical final pay plan in which an employee with a 30-year career would earn about one-third of lifetime pension benefits in the final five years of employment. But the employee with 10 years of service would receive only about 14 percent of the possible lifetime benefits. Final pay plans are nearly worthless for these shorter-term public employees.

A DIFFERENT WORKFORCE CULTURE

The poor treatment of short-term employees impacts the culture of the government workforce. Some public employees who are burned out in their jobs or who would be more productive or highly promoted in a job outside government are discouraged from leaving because a disproportionate amount of their potential back-loaded retirement benefits would be lost. The current system is fundamentally unfair to those who do not spend most of their career in a government job.

> Under the cash-balance plan, the rewards for career government service would be reduced.

There are other implications for the final pay design. For example, final pay plans also encourage spiking, in which higher pay, promotions or new jobs are awarded to well-connected individuals or favored employees just before retirement age to boost retirement income. This has long been a controversial issue in Louisiana.

Through legislation in recent years, LASERS has partially improved some of these circumstances. Some limits have been placed on spiking and the use of overtime pay toward final average compensation calculations. Employees hired after 2010 can become vested after five years rather than the previous standard of 10 years, although their benefit accumulation at that point is relatively small.

Theoretically, a young employee leaving after 10 years of service in a cash-balance plan would own a retirement account that, if invested further over time, would be of greater value than the benefit for someone leaving after 10 years of service in a regular defined benefit system. There would be less of a deterrent against job mobility, both into and out of government service. The risks implicit in some of the actuarial assumptions of defined benefit plans, such as predictions related to future salary growth, would diminish. What's more, the state would not be responsible for cost-of-living adjustments.

The actuary for the Legislative Auditor has provided an analysis showing the difference in a state employee's wealth accumulation under the current plan versus the cash-balance plan. Employees hired at ages 25 or 35 would tend to accumulate substantially more wealth in the cash-balance plan in their first 10 to 20 years on the job compared with the existing defined benefit plan. By age 60 the effect would switch and those individuals would have accumulated more wealth under the defined benefit plan.

The governor's actuary foresees scenarios in which employees who serve for short or long periods in a cash-balance plan would, at the time they left, have accumulated a much smaller benefit value than under the current defined benefit plan. The younger employees could leave and re-invest their cash-balance accounts so that at retirement age their cash-balance benefit could potentially be greater than the retirement-age value of a defined benefit package. But the bottom line for employees is that, under the governor's analysis, their benefit would be smaller in a cash-balance plan. This conclusion appears to coincide with the administration's view that the state's contributions for new members in the retirement systems would be reduced by as much as 35 percent over 30 years under cash balance.

According to the governor's actuary, the state's expense for maintaining the new cash-balance plan is expected to be lower than under the existing plan and the benefits are expected to be lower as well. State contributions would be reduced by $52 million over the first five years and by $3.8 billion through 2040, though many variables apply to those calculations. An employee after 10 years under the cash-balance plan would accumulate a retirement benefit about 36 percent less than under the defined benefit plan. After 30 years the cash-balance employee would accumulate about 14 percent less than under the defined benefit plan.

A SERIES OF UNFORTUNATE EVENTS

The Legislative Auditor's actuary predicts the state's costs would increase under a cash-balance plan, although no estimated figure for the increase was reported. If in fact the state expense to support the cash-balance plan is similar or more than the expense to support the current defined benefit plan, then the governor's proposal would seem to offer less bang for the buck. The state would be paying the same or more while employees would be getting a smaller benefit. The administration needs to make a convincing argument that this is not the case.

Under the cash-balance plan, the rewards for career government service would be reduced. Moving away from a final pay plan could cause greater average job turnover, which might lead to salary increases for government positions and changes in actuarial assumptions that would impact the system.

Along these lines, the Auditor's actuary and some other critics foresee a series of unfortunate events in the wake of a cash-balance plan. It goes as follows: employees under the cash-balance plan would be more likely to leave government because their plan would be more portable and they would not be walking away from the large balloon of benefits offered at retirement age under the defined benefit plan. This new set of incentives would lead to greater staff turnover and generally shorter terms of government service. Retirement system investors would have to take into account this shorter duration of benefit liabilities under the cash-balance plan and therefore would have to invest more conservatively. Those conservative investments would have lower investment returns, which would lead to higher contributions by the state to maintain the program. The changed nature of the investment portfolio would cause the state to spend more to keep the retirement system financially sound.

The governor's actuary disagrees, saying the potential turnover rate is being greatly exaggerated and that the need to move the retirement portfolio into short-term investments is being overstated. Also, the accounts for the cash-balance and defined benefit plans would be co-mingled and the large majority of state employees would continue to be covered by the current defined benefit plan for many years.

THE PROBLEM FOR NEW EMPLOYEES

In Louisiana as in many states with defined benefit plans, the retirement outlook for new employees has been increasingly diminished. New employees – since they have no previous contract with the state – are easy targets for making the terms of retirement less generous in order to realize state cost savings. For example, newer employees in LASERS pay a higher retirement contribution rate.

> New employees under the existing system have been and likely will continue to be vulnerable to legislation curtailing their benefits.

Regular employees in LASERS hired before mid-2006 have a menu of options, including some very generous terms that are costly to the state. For example, they can take full retirement at 55 with 25 years of service and full retirement at any age with 30 years of state employment. The terms were changed in 2006 and in 2011. Now, the minimum retirement age with full benefits is 60. Still, a LASERS employee with 20 years of service can retire at any age with a reduced benefit.

The governor in this session is trying to change the benefit conditions for current employees, not just new ones. But new employees under the existing system have been and likely will continue to be vulnerable to legislation curtailing their benefits. This is another consideration in determining the value of moving to a cash-balance plan.

THE IMPACT ON EMPLOYEE BENEFITS

What is a fair retirement benefit for employees?

Many public retirement systems have offered full retirement packages to employees under 60, an offer that is unavailable to most in the private sector and expensive for taxpayers to maintain. Louisiana in recent years has moved incrementally toward more conservative terms for retirement. There was a growing consensus, even among the retirement systems, that the state had been offering employees too much too soon, at a high cost to taxpayers. Changes implemented in 2006 and 2011 for new hires confirmed this trend. The governor in the current session is trying to raise the retirement age and change other terms for existing employees.

Employees would face lower benefits and other disadvantages under the cash-balance plan.

AARP, the advocacy organization for people over 55, suggests that the goal for a retirement package should be to allow people to remain self-reliant. Some retiree advocates say people moving from work to retirement should have enough regular income to maintain their standard of living. Many retirement system analysts suggest that plans should be designed to provide a certain percentage, or replacement ratio, of a person's working income. This might be 70 percent or even 90 percent.

Under the governor's scenarios, a cash-balance employee completing 30 years of service under conservatively optimistic market conditions would receive a retirement benefit with a replacement ratio of 59 percent, versus a ratio of 69 percent for the same person under the current defined benefit plan. If that person had been enrolled in Social Security, the federal benefit would have been at a 31 percent replacement ratio. Under a more pessimistic market scenario, the same person would receive only a 32 percent replacement ratio with cash balance versus the same 69 percent under the defined benefit plan. That scenario predicts a 22 percent replacement ratio under Social Security.

The retirement benefits of the cash-balance plan would exceed Social Security's benefits for workers with 20 or 30 years of service, according to the governor's analysis. But the cash-balance benefits are worse than Social Security for employees with 10 years of service.

There are other disadvantages for employees under the cash-balance approach. Those who leave employment before age 60 will forfeit subsidized retirement health insurance. The version of the cash-balance plan passed by the House Retirement Committee contained very minimal compensation for survivor and disability benefits. These benefits are offered more generously by the current defined benefit program and Social Security.

The need for fair retirement compensation frequently collides with the need to conserve taxpayer dollars. But much of the concern about providing sufficient retirement income for public employees could be expressed equally as well about many people's retirement plans in the private sector. Generally for people in the United States, not enough is being put aside or invested to prepare adequately for retirement, particularly in an era of greater longevity. Young people in particular need to be more investment-conscious. Ultimately the best solution is for Louisianians, and all Americans, to adopt a stronger set of values about putting more working income aside to prepare for the future.

OTHER OPTIONS FOR REFORM

Nebraska started a cash-balance plan in 2003 and is the only state to have one. Its overall system, which includes Social Security and a 5 percent return guarantee on cash balance, is fairly generous. Local governments in Texas have operated under a statewide cash-balance system since 1948. The Kansas Legislature is currently considering a cash-balance plan, which was designed according to the recommendations of a special study commission.

The proposed cash-balance plan is by no means the only option for a new retirement system.

The proposed cash-balance plan for Louisiana is by no means the only option for a new retirement system for new employees. Some states have adopted hybrid systems in which a defined contribution plan is paired with a traditional but modest defined benefit pension, providing nominal income security for retirees topped by a riskier investment portfolio. In this attempt at a best-of-both worlds arrangement, employees own both types of plans.

Last year, Rhode Island, which was suffering from soaring retirement costs, added a defined contribution plan and revised its defined benefit plan by reducing employee required contributions and benefits for members as of July 1, 2012. Benefits accrued through that date will remain unchanged. Proponents of the change managed to win broad support among various stakeholders by focusing on the data and by reaching agreement on what a fair retirement income benefit ought to be. A common goal was identified, and then a new system was created to reach that goal.

Another type of hybrid system, suggested by the Center for Retirement Research, is a "stacked" plan that limits the risk to taxpayers. In this system, a defined benefit plan would cover employees up to a certain annual salary, such as $50,000. For workers who do not earn more than $50,000, this defined benefit plan would be the only retirement coverage. For employees earning more than $50,000 annually, their pay above that threshold would be covered by a defined contribution plan. The lower-income workers would have a single retirement plan, while the higher-income workers would have two, stacked plans.

"Meaningful defined benefit plans could remain as a secure base for the typical public employee, and defined contribution plans could be 'stacked' on top to provide additional retirement income for those at the higher end of the pay scale," the Center's study says.

SUMMARY

The state should be seeking an opportunity to lower taxpayer risks in the long run by commencing a new type of retirement plan for a new generation of state workers. Although a new plan would not remedy the state's existing unfunded accrued liability, it could provide a new retirement platform with less risk of repeating prior mistakes.

The governor's cash-balance proposal has been presented as a candidate to fulfill this role. It would be unique among public sector plans: Few other state or local governments have adopted cash-balance plans and the governor's would appear to be the first to base employee interest credits on a rate of return tied to market performance. It has the quality of providing at least a modest secure income base for retirees and an upside potential for them if investment markets cooperate. It is a less volatile but not riskless system for taxpayers. Tax dollars could be further protected if the plan were adjusted to allow the state to take more than a 1 percent buffer under certain highly favorable market conditions.

The governor's plan would not be structured to provide for cost-of-living adjustments, which are beneficial to retirees but costly under the current system. The cash-balance compensation method would abandon the current "final pay" formula that leads to spiking and other bad effects and it would be portable upon departure from government service. However, some believe this aspect of the plan does raise some risk of higher costs and a more conservative investment portfolio due to higher employee turnover.

> The state should be seeking an opportunity to lower taxpayer risks by commencing a new type of retirement plan for a new generation of state workers.

Unfortunately, competing actuarial estimates offer wholly different views of the costs and impacts of the cash-balance program, so much so that the state might consider a third opinion. The administration needs to make a convincing argument that its plan is cost effective and that tax dollars will not continue to be spent at the same rate only to result in lower benefits to retirees. If the cash-balance plan is implemented, the state should monitor the annual expense and be prepared to adjust the terms if the new system is not cost-effective. The current legislation should be designed to allow the state flexibility to alter the terms on a non-retroactive basis in a manner that is soundly constitutional

Legislators should place more focus on the discussion of what constitutes a fair benefit. In this vein, and considering the lack of Social Security benefits, the cash-balance plan would be improved if it, or a separate insurance plan, offered a better benefit for survivors of an employee who dies before retirement. This provision could be added at a relatively minor additional cost.

The governor's plan is worth serious discussion. If it is deemed inadequate as the debate ensues and more information about its potential impact is released, the state should not give up looking for the right solution for a new type of Louisiana retirement plan.

ADDITIONAL FACTS OF INTEREST

-The LASERS retirement system covers about 54,000 rank-and-file state employees and about 5,600 employees in hazardous duty jobs, mainly corrections officers. Under the House committee version of the bill, the cash-balance plan would be only for employees hired after June 30, 2013, and would not affect new hazardous duty workers. The LASERS system provides benefits to about 41,000 retirees. The average monthly benefit for retired rank-and-file workers is $1,811. LASERS also has about 50,000 inactive members, including past employees, who will later be eligible for benefits. About 2,500 people participate in the Deferred Retirement Option Program.

-The Teachers' Retirement System of Louisiana covers more than 83,000 employees, including public school teachers and college personnel. Teachers provides benefits to about 64,000 retirees. The average benefit for a TRSL regular plan service retiree in 2010 was $1,954 per month. Teachers has 5,745 inactive members and about 3,100 participate in DROP.

-There are many critics of the accounting methods used by public pension systems that use measures of actuarial rates of return rather than realized rates of return on their investments. The Platte Institute for Economic Research, based in Omaha, Neb., released a report last year critical of some aspects of Nebraska's cash-balance government retirement plan. Nebraska, which guarantees a 5 percent annual return on account balances no matter what happens in the real market, is the only state that offers a cash-balance retirement plan. While noting advantages of the Nebraska program, the report also raises the concern that both cash-balance and defined benefit plans use "a set of accounting rules that economists almost universally believe to understate pension liabilities and hide investment risks that are borne by taxpayers." This concern is reflective of a larger and rather significant national debate about the accounting methods favored by pension managers. The proposed cash-balance plan for Louisiana might also be subject to this critique, although probably less so than Nebraska with its 5-percent return guarantee.

-The Legislative Auditor reported that actuarial recalculations have added $1.2 billion to the new Unfunded Accrued Liability for all four systems.

-A steadily rising payment schedule established in the early 1990s to address the UAL had assumed the annual increases would match the growth of aggregate government payroll, which did not happen.

-Under the cash-balance plan, it is not clear whether an employee account would continue to gain interest credits if a worker departed government service and left the account in the retirement system rather than moving it into a private investment.

-Because of the changes in benefit terms under the defined benefit program, the state's contribution to the normal cost for newer employees is lower than for older employees. Whereas state employers will contribute about 8 percent of payroll toward the normal costs of more veteran LASERS employees, the state contribution to the normal cost for employees hired since 2006 will be about 4 percent, according to the Legislative Auditors actuary. For a valid comparison of cost savings, the state expense for maintaining a cash-balance plan must be measured against the cost of maintaining the existing plan for new hires. Recent revisions to the existing plan already have led to some cost savings for the state.

-Social Security benefits are not portable between the private sector and government employers, like Louisiana, that do not participate in Social Security. This factor can have negative tax and benefit implications for people who move between private and public service.

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