



Teacher Pension Reform

By Chad Aldeman

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What Are Public-Sector Pensions?

- Formula-based benefit calculation
- Monthly payments guaranteed for life

$$\begin{array}{ccccccc} \text{Multiplier} & \times & \text{Salary} & \times & \text{Years of} & = & \text{Benefit} \\ (2 \text{ percent}) & & (\$50,000) & & \text{service} & & (\$25,000) \\ & & & & (25) & & \end{array}$$

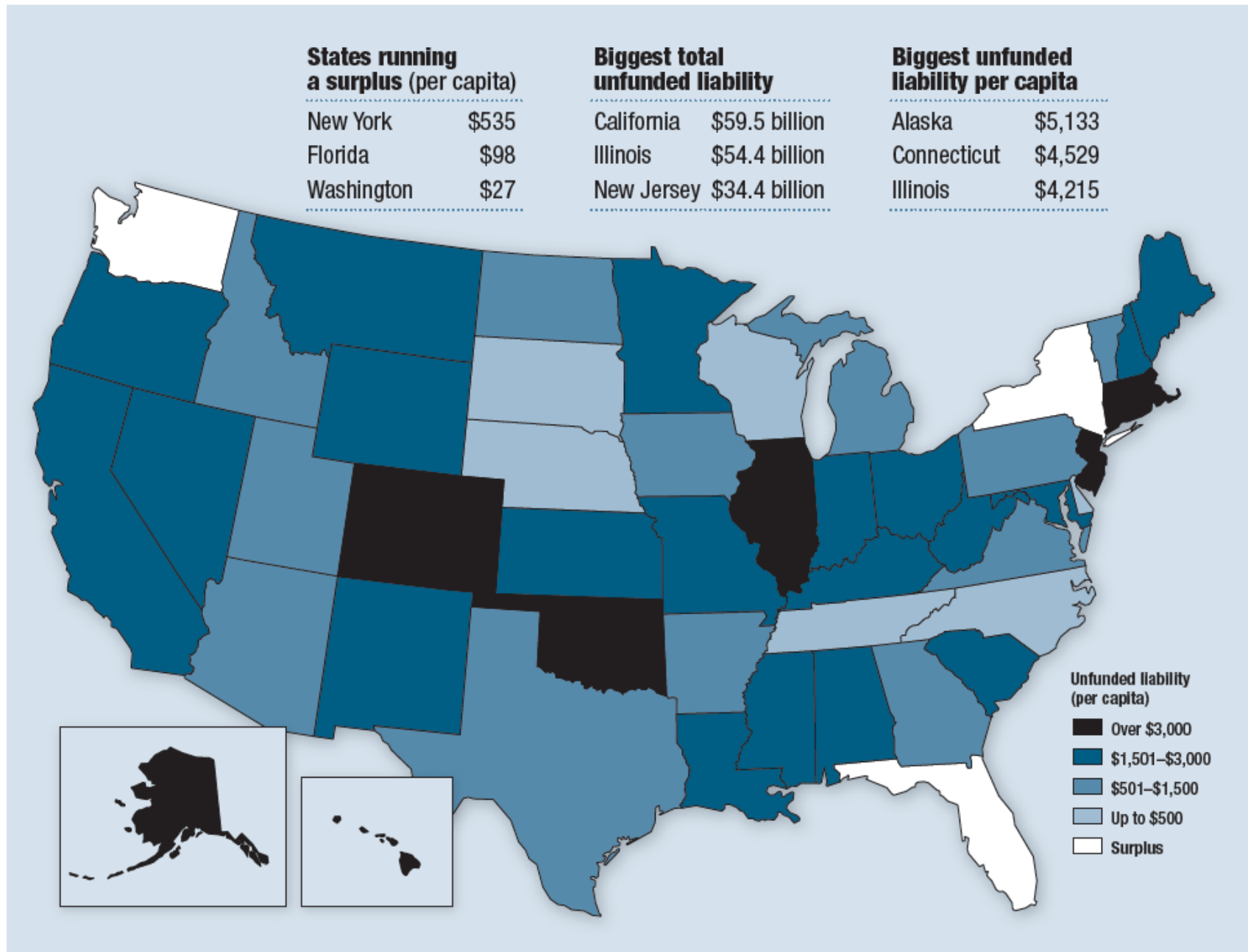
The Problems with Public-Sector Pensions

- The Underfunding Problem
- The Divergence Problem
- The Human Capital Problem

The Underfunding Problem

- Heavy reliance on financial assumptions
- Stock market decline AND benefit enhancements contributed to current conditions
- 47 states underfunded by \$500 million

Figure 4. Forty-Seven States Have Unfunded Liabilities



Note: Authors' calculations from "The Trillion Dollar Gap," (Washington, D.C.: The Pew Center on the States, February 2010).

Status of Louisiana Teacher Pensions

- 88,000 active members, 62,000 retirees
- Unfunded liability of \$9.3 billion (59.1% funded)
- 7.8% long-term return on investments (less than projected)

The Divergence Problem

- Public-sector retirement is now different from private-sector retirement
- Private-sector workers bear more risk
- Public-sector workers retire earlier
- Public-sector retirement plans have not kept up with a changing workforce

Defined Benefit Plans From the Employee's Perspective

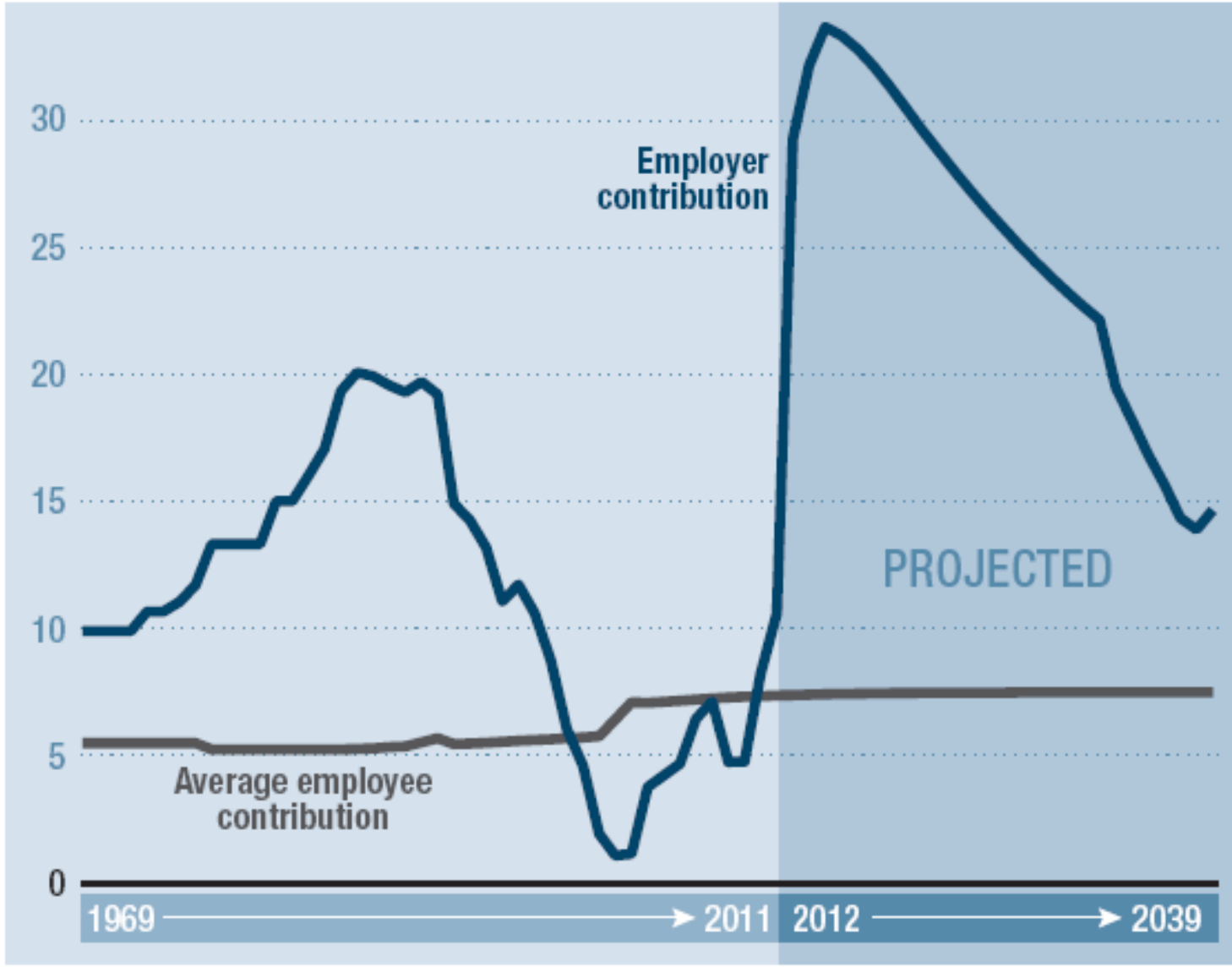
- Guaranteed payments for life, adjusted for inflation
- Strong rewards for longevity
- Little portability
- Few choices

Defined Benefit Plans From the Employer's Perspective

- Tricky assumptions
- Unpredictable contributions
- Rewards longevity, good and bad

Pennsylvania's Employer Contributions Fluctuate Wildly

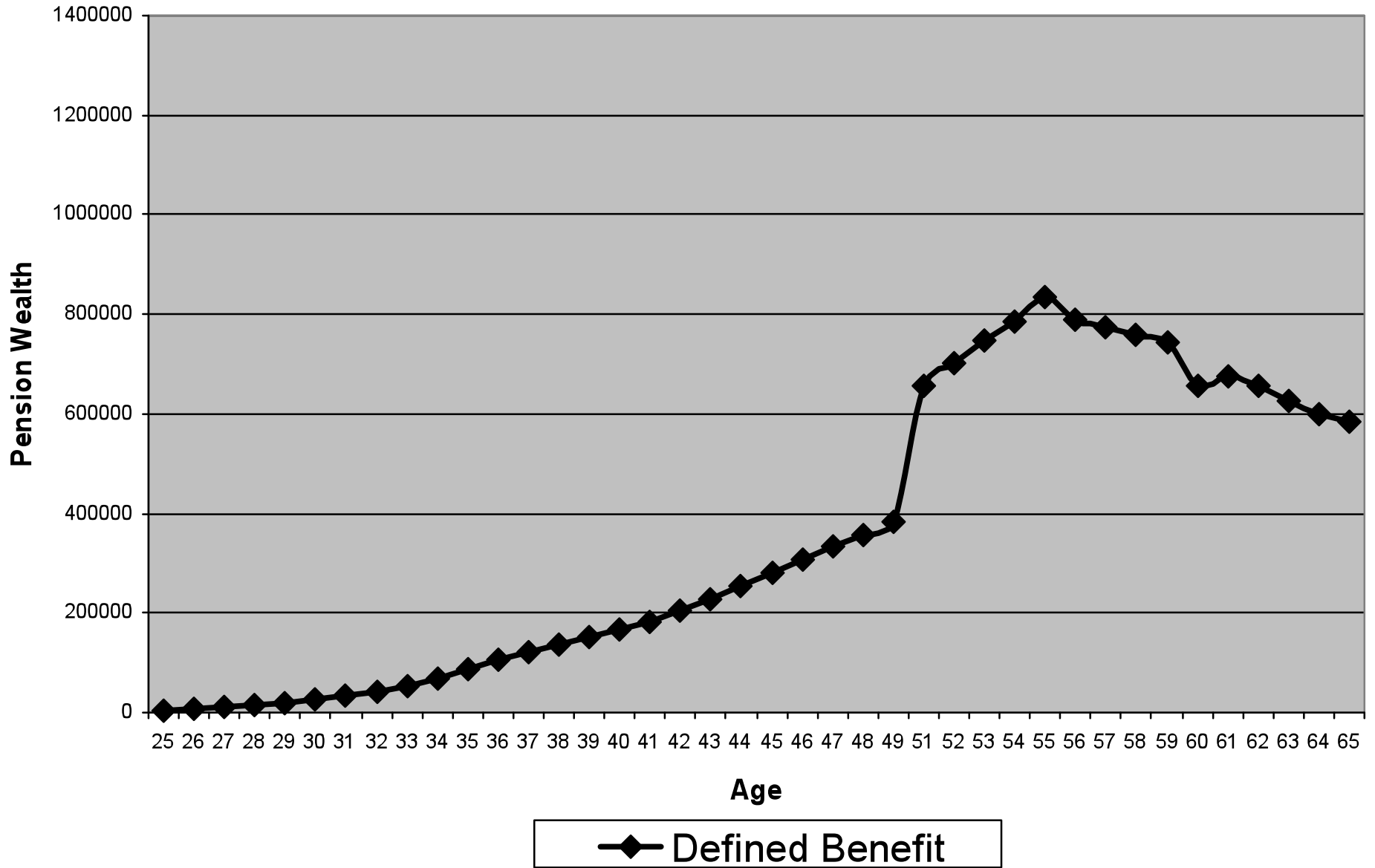
Average contribution (% of compensation)



Louisiana's Defined Benefit

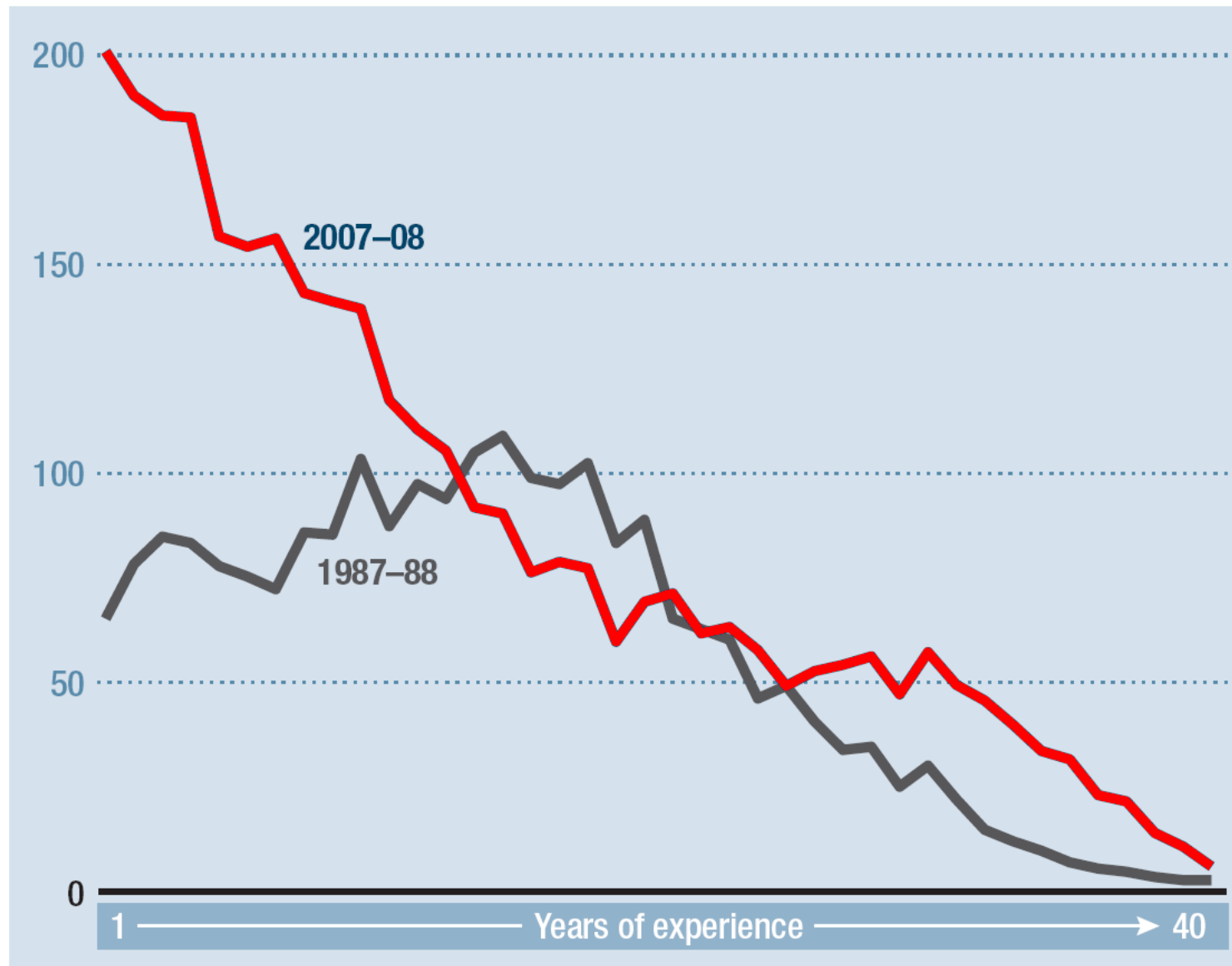
- Formula based on years of experience, final average salary (highest 3 years), and 2 or 2.5% multiplier
- Guaranteed monthly payments from retirement until death, adjusted for inflation
- 25-year longevity reward
- Bad deal for early leavers

Pension Wealth Accrual Under Louisiana Defined Benefit



Teachers Today Have Less Experience

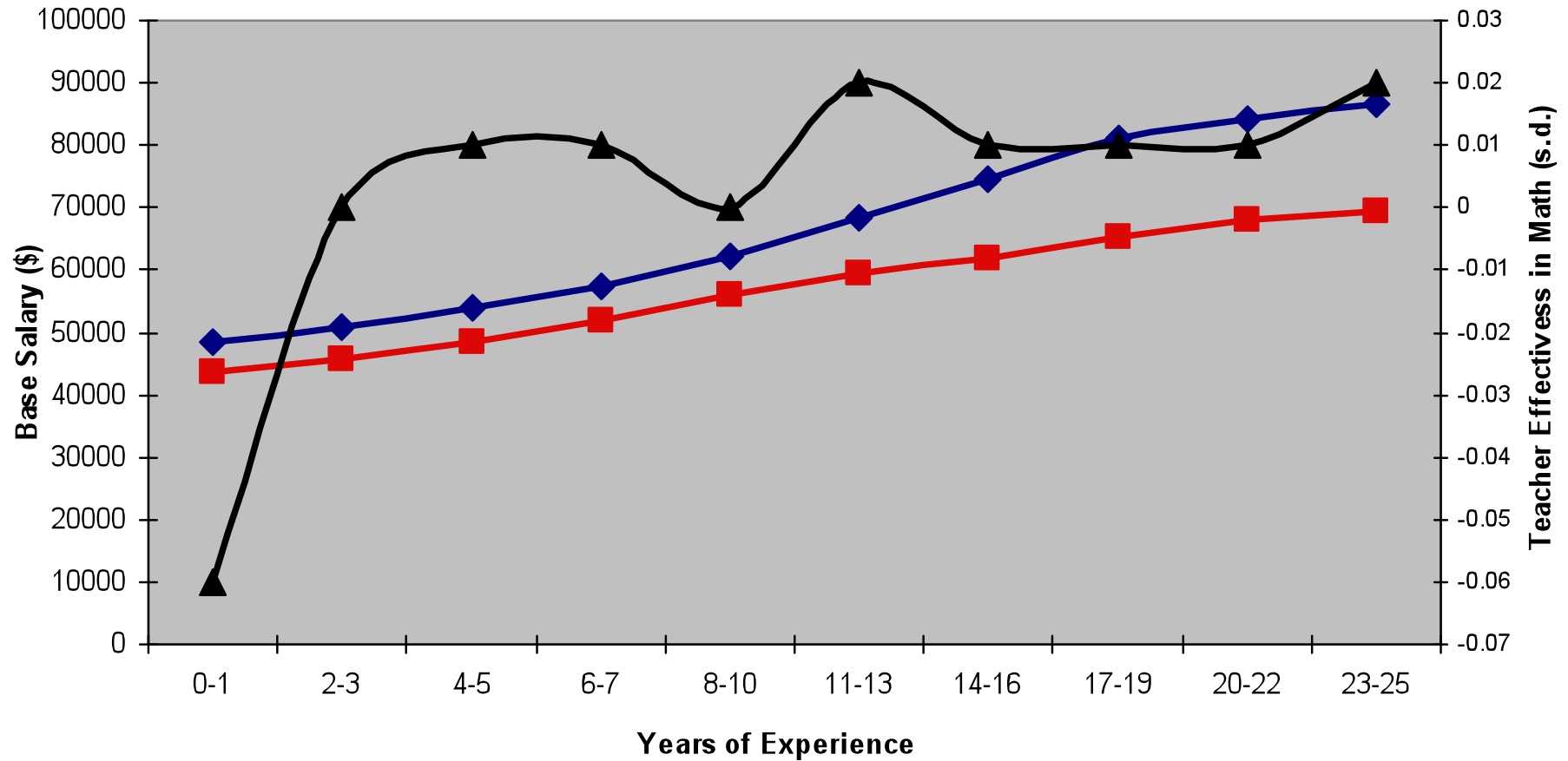
Number of teachers (thousands)



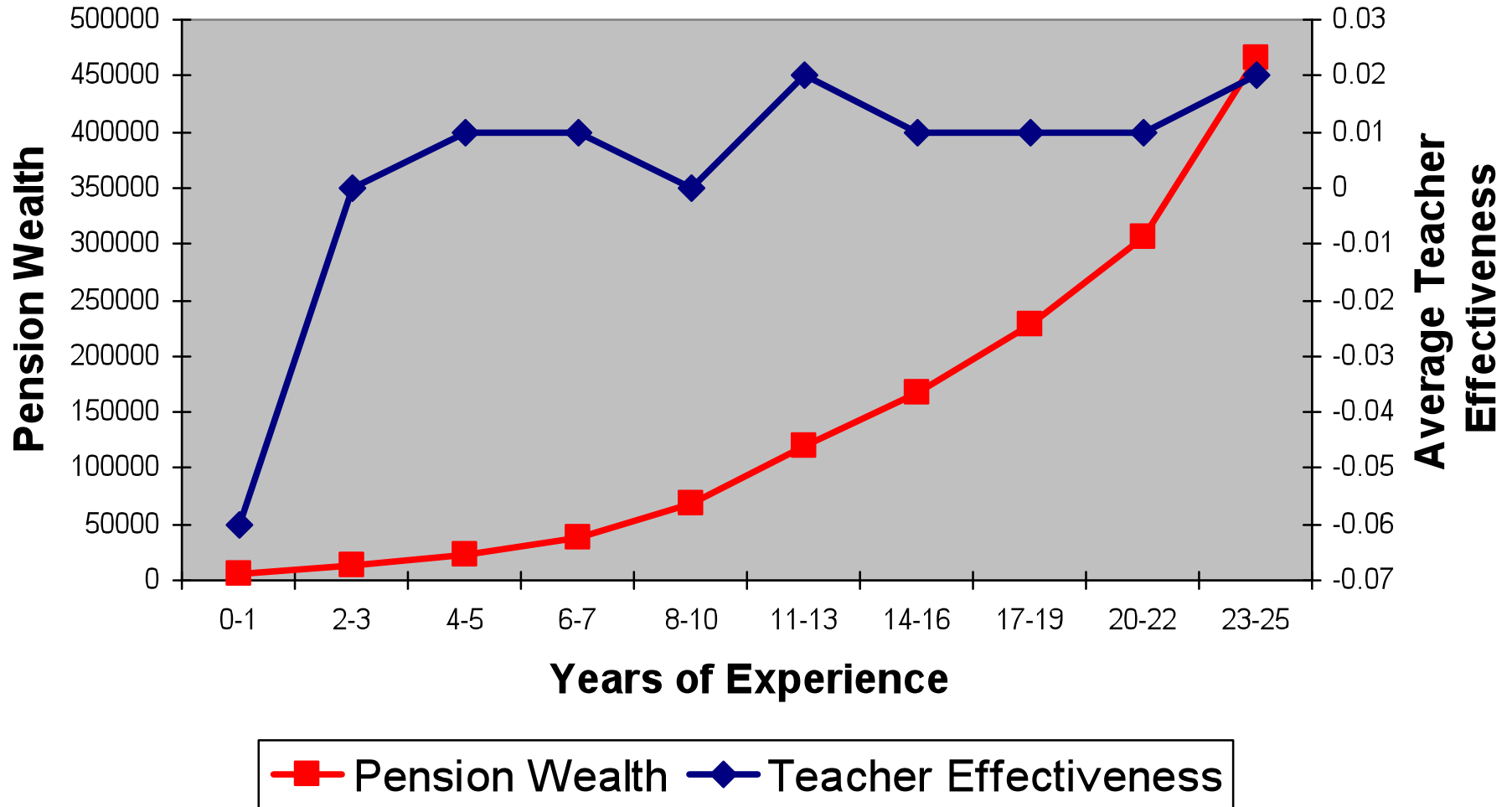
The Human Capital Problem

- Large-scale recruitment issues
- Retention issues
- Policies designed for a stable and localized workforce that is changing
- Few financial or non-financial incentives for quality

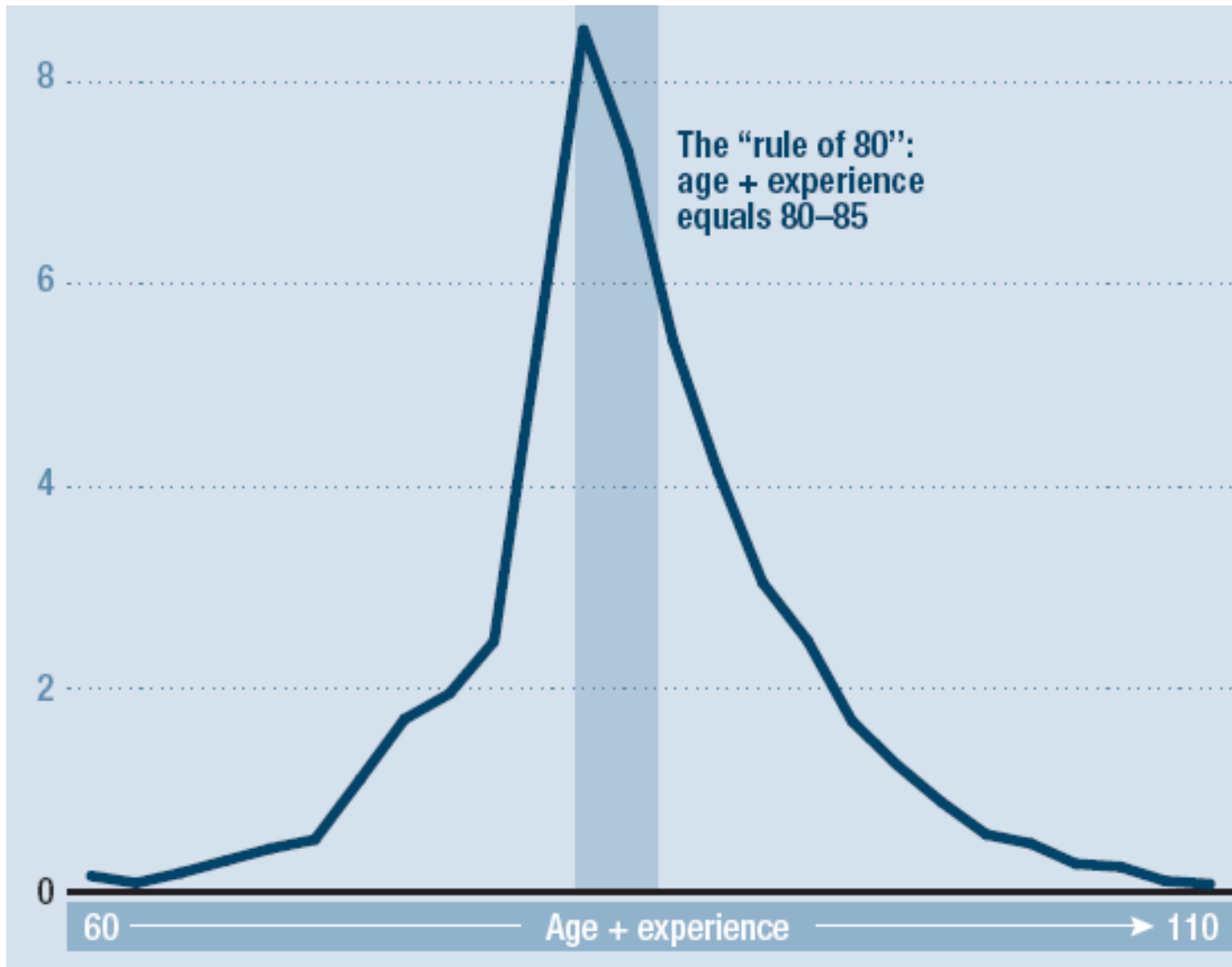
Teacher Salaries Compared to Teacher Effectiveness



Defined Benefit Pension Wealth Accrual Compared to Teacher Effectiveness Gains



Teachers Time Their Retirement

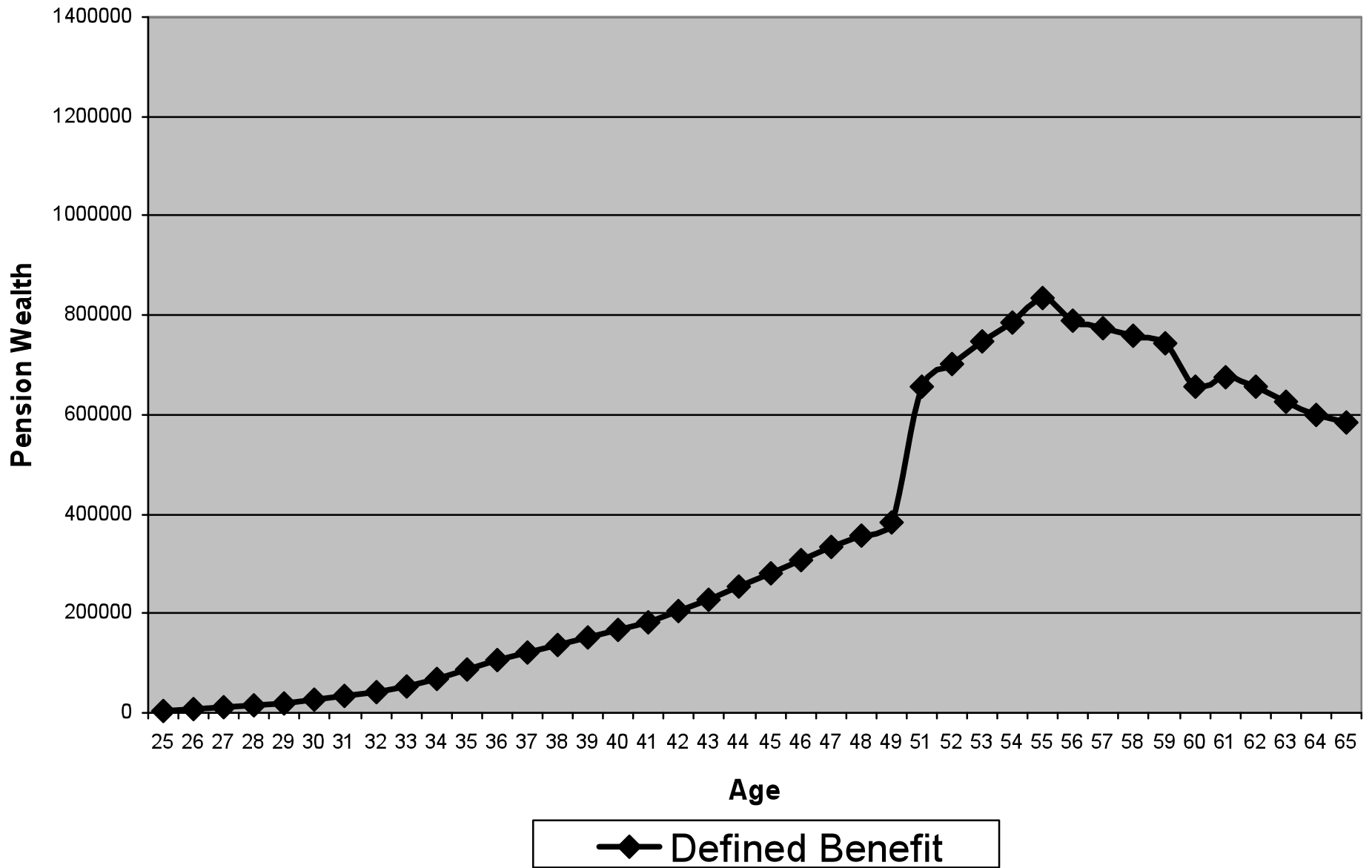


Do Other Pension Structures
Address These Issues?

Comparing Different Pension Structures

- 25-year old teacher
- Begins teaching in 1975
- Same contribution levels
- Real interest rates, stock market returns, plan assumptions

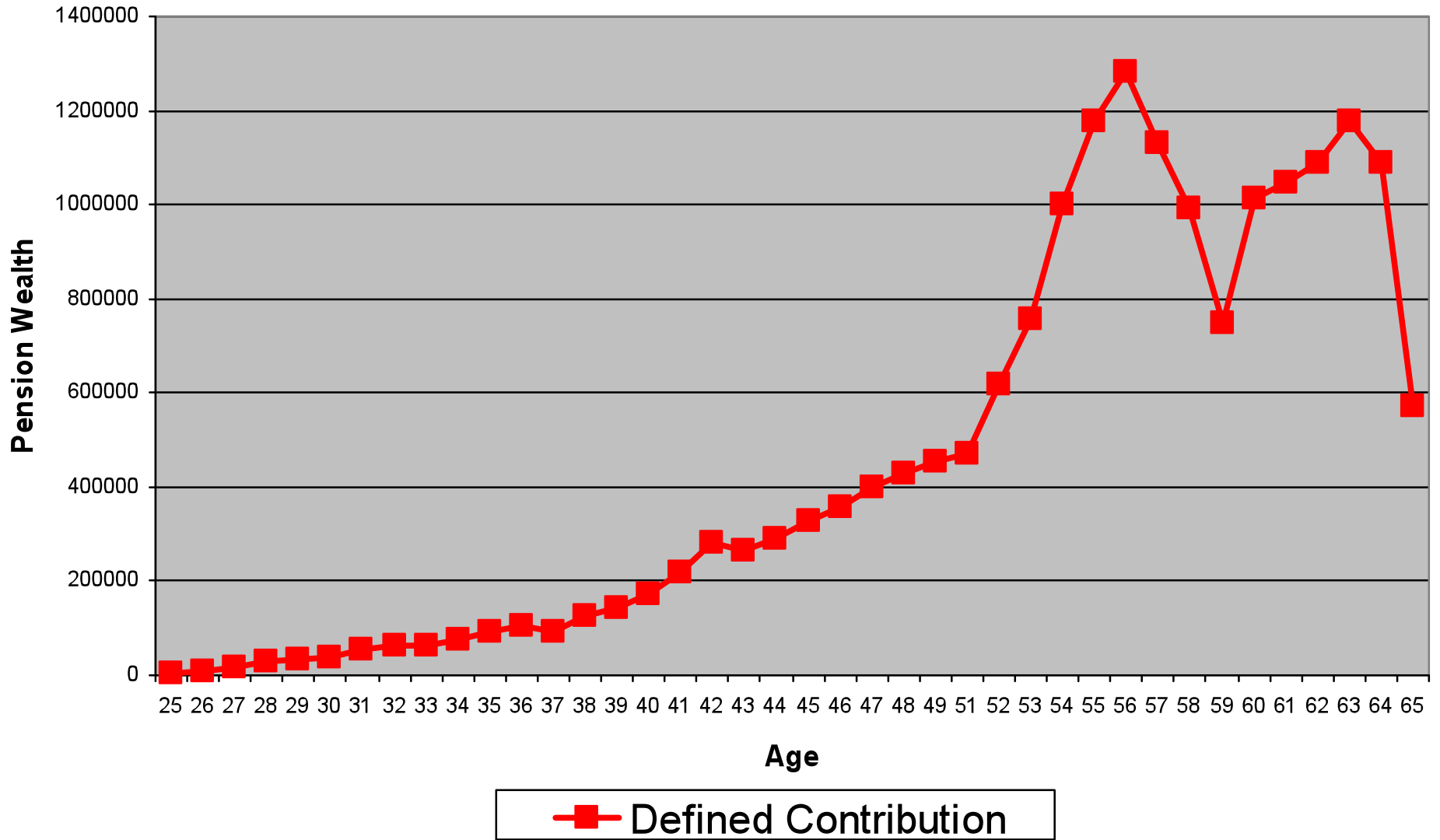
Pension Wealth Accrual Under Louisiana Defined Benefit



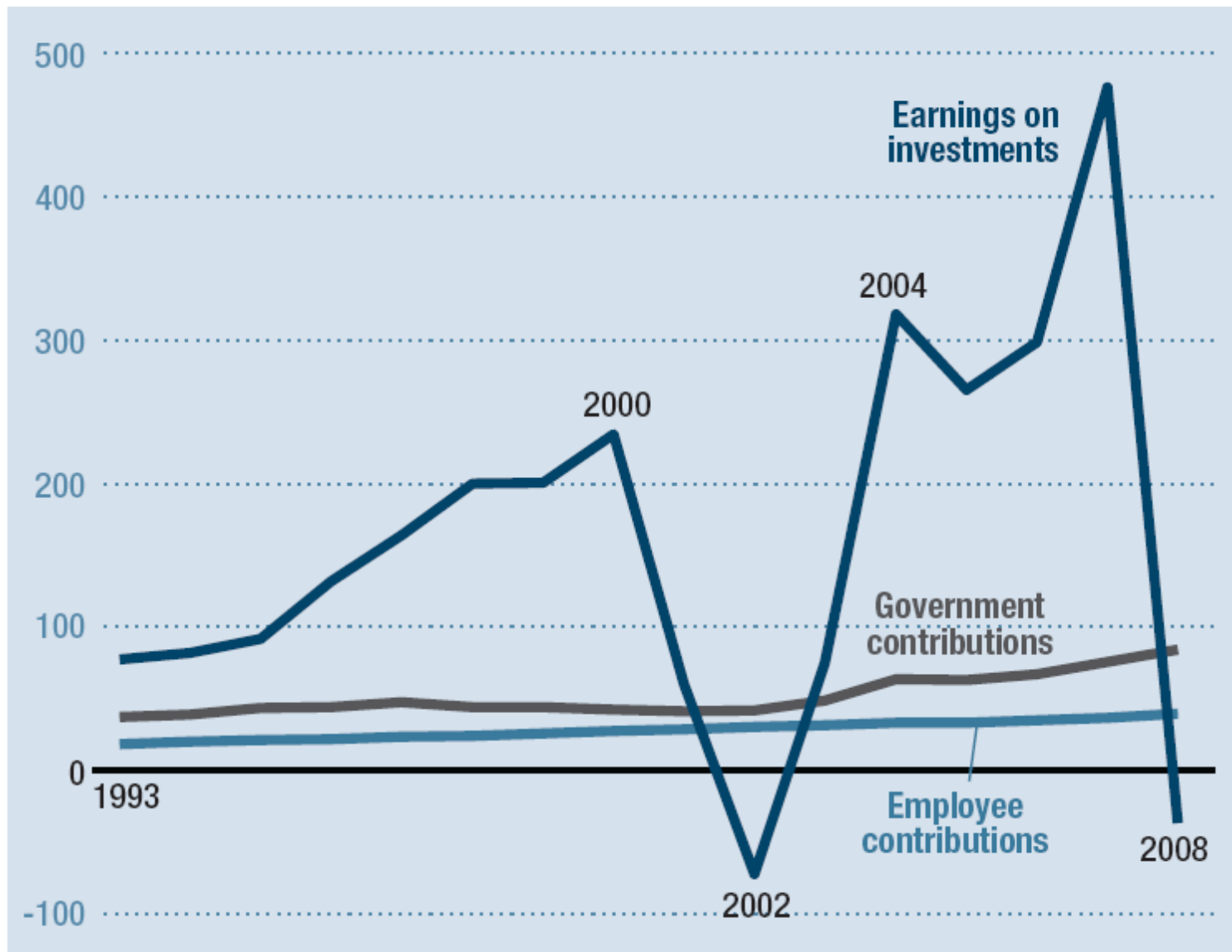
Defined Contribution Plans

- 401k (or 403b)
- Employer sets contributions in advance
- Contributions are predictable
- Unpredictable outcomes
- Risk born by employee

Pension Wealth Accrual Under Hypothetical Defined Contribution



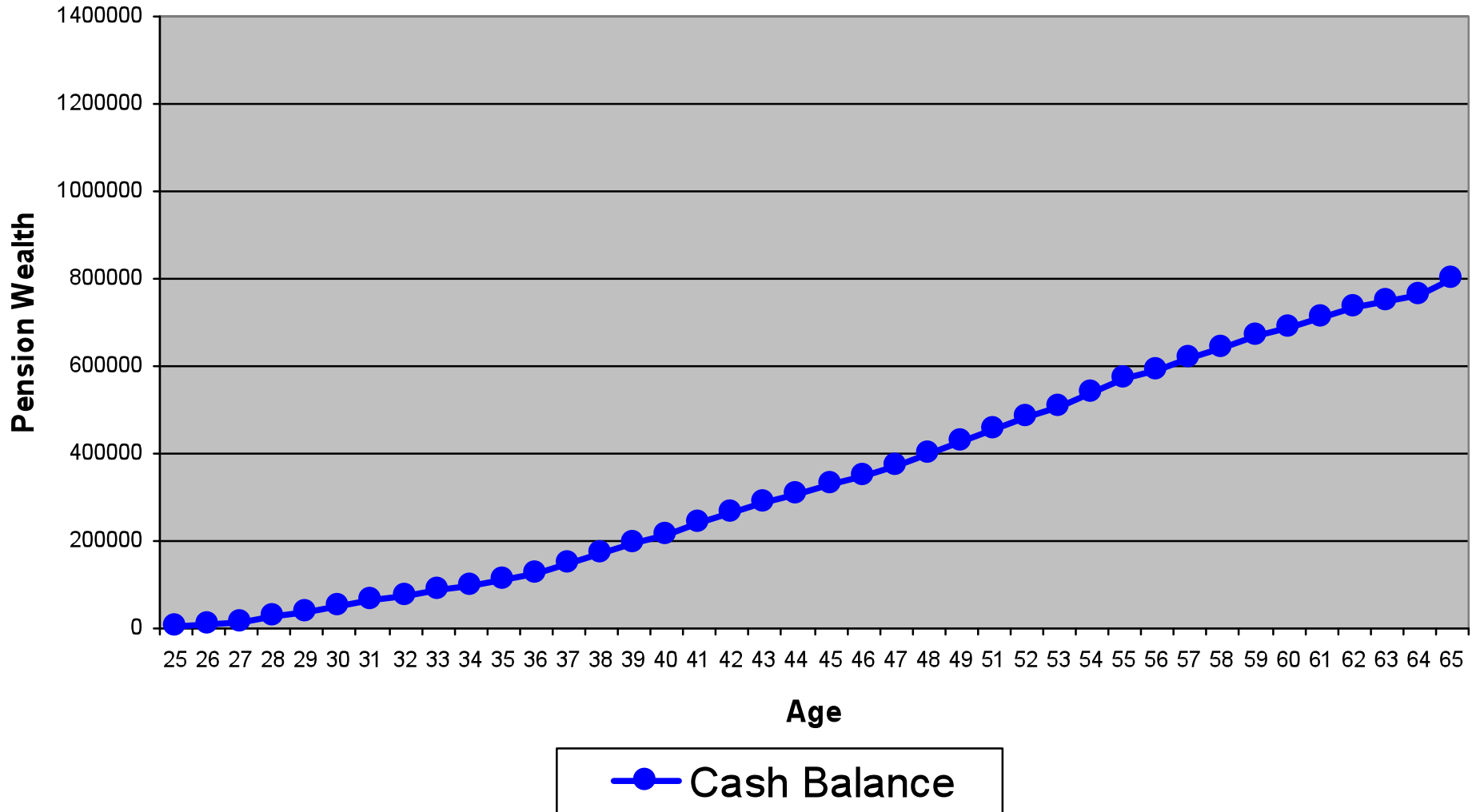
As Plans Get Bigger, Earnings Matter More



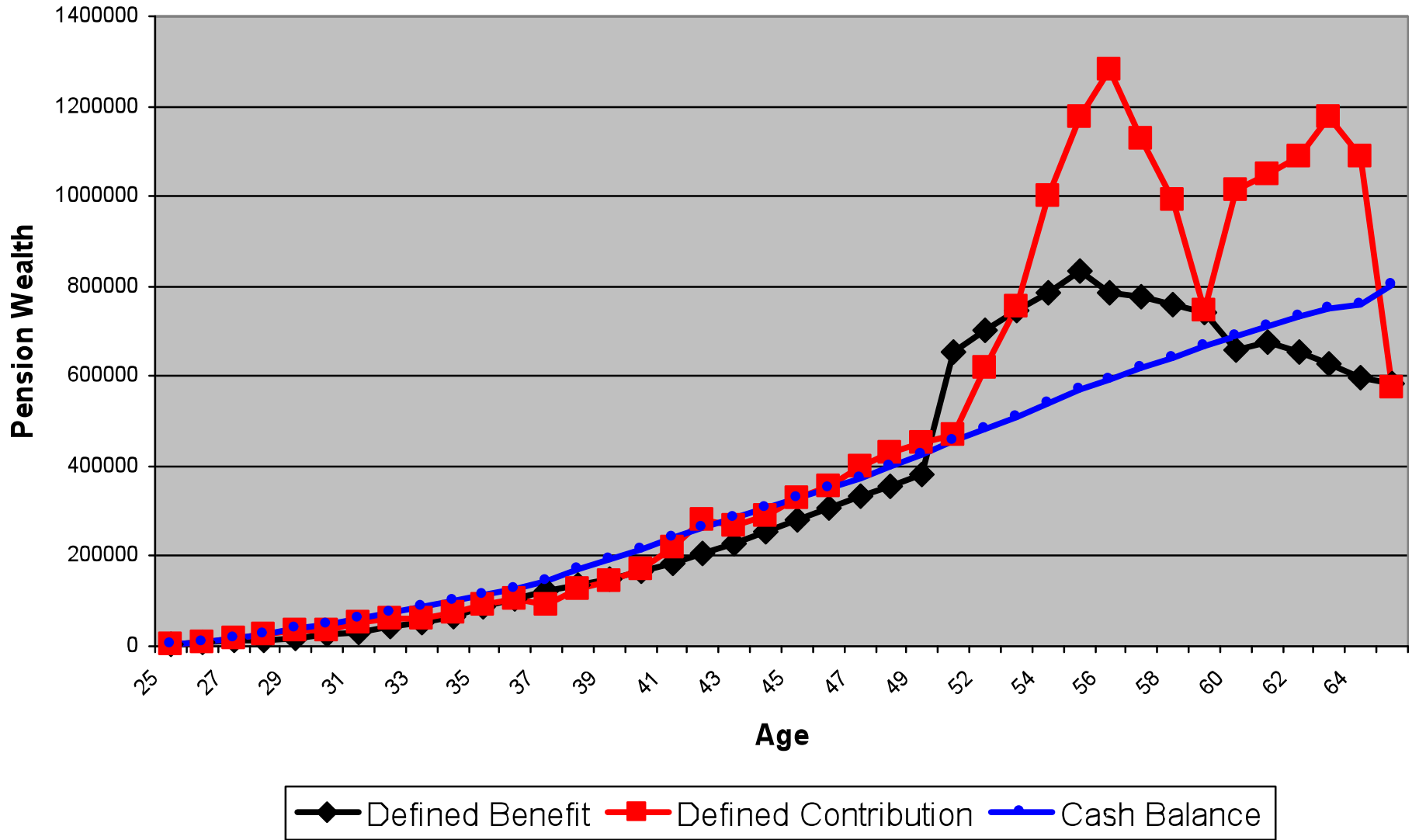
Cash Balance Plans

- Legally a defined benefit
- Employer sets contribution and investment credits
- Conservative investments yield steady accumulation
- No big leaps or dives

Pension Wealth Accrual Under Hypothetical Cash Balance



Pension Wealth Under 3 Options



Barriers to Reform

- Legal restrictions bar changes for existing members
- Strong political forces
- Conversion costs

What Should States Do?

- Make regular contributions
- Close loopholes
- Join Social Security
- Use phase-in periods
- Consider alternatives (cash balance, defined contribution, hybrid)

Lessons for Reform

- Financial problems loom large
- Problems more than just financial
- Pensions have not kept up to changing teacher work force
- Minor tweaks not sufficient

For more information, visit the Education Sector website at:

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