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Not So Modest: Pension Benefits for Full-Career State Government Employees

By Andrew G. Biggs

City and state governments around the country are pursuing reforms to address the rising costs of public employee pension plans. In response, public employee unions and pension plans themselves often portray these benefits as “modest.” In reality, public pension plans offer long-term government workers benefits that make them among the best-off retirees in the country. Indeed, the average full-career government worker in eight states retires as a “pension millionaire,” with 23 states paying \$750,000 or more in lifetime retirement benefits. Drastic benefit reductions for current retirees would be unfair, but reforms that make public- and private-sector pensions more comparable should be on the table.

In presenting their benefits as “modest,” public pension plans and employee advocates commonly cite low average payments to retirees. For instance, the American Federation of State, County and Municipal Employees (AFSCME) declares that “the average AFSCME member . . . receives a pension of approximately \$19,000 per year after a career of public service.”¹

This statement is false: for those who spend a career in government, public-sector pensions are far more generous. The average benefit for a full-career state government employee is roughly twice the \$19,000 figure claimed by AFSCME, and in some states substantially higher. The low average benefit payments cited by pensions and public employee unions are produced by including employees who do not spend a full career working for the government. Short-term government employees do receive modest pension benefits, and many would be better off with a defined contribution (DC), 401(k)-type plan. Full-career public employees retiring today, by contrast, receive pension benefits that place them among the highest-income retirees in their states.

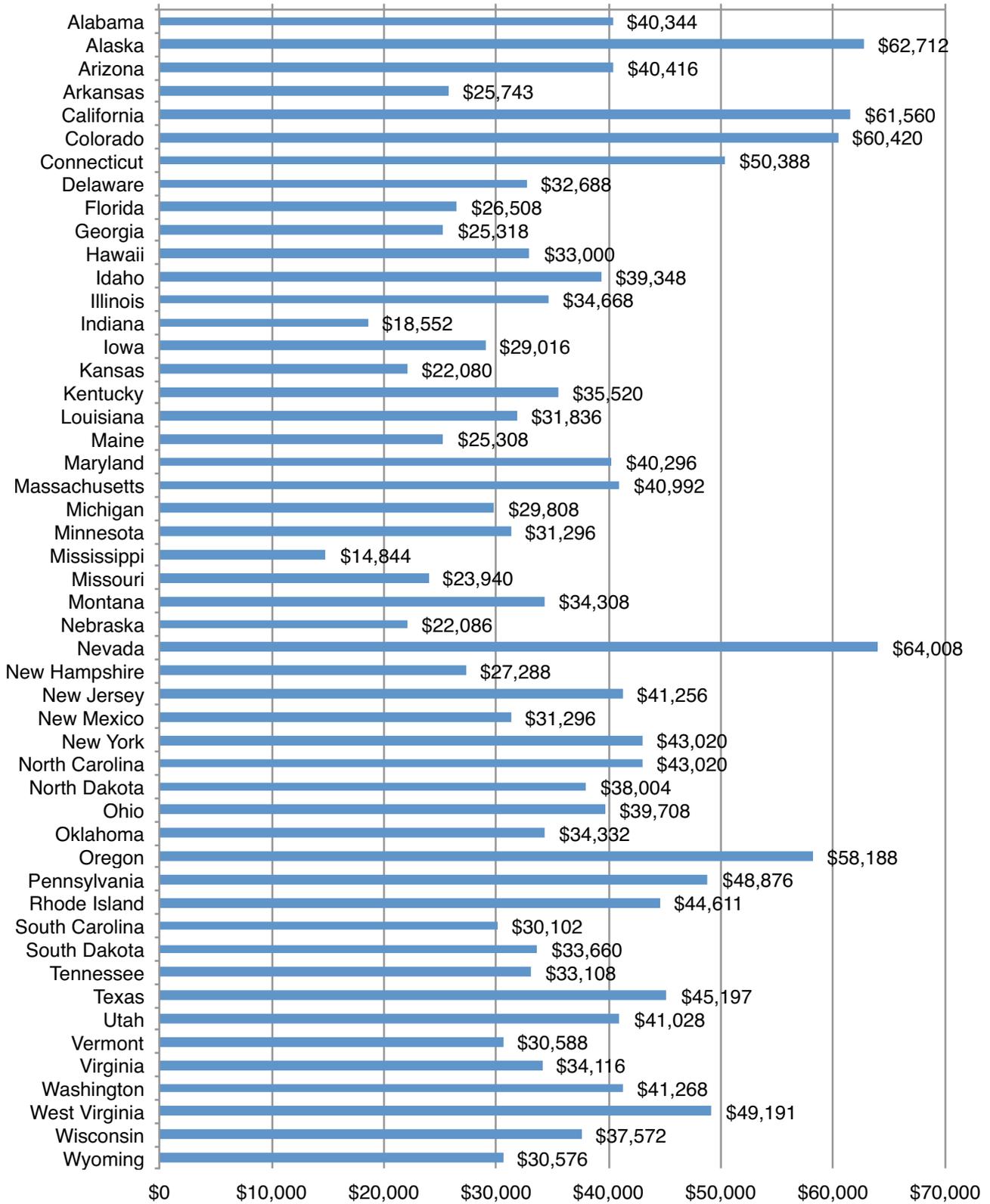
What Full-Career Government Employees Really Receive

On a state-by-state basis, I have tabulated the benefits an average full-career state government employee who retired in 2011 or 2012 will receive.² In most cases, data are compiled directly from the Comprehensive Annual Financial Reports (CAFRs) published by public plans. For instance, the New York State and Local Retirement System’s CAFR reports that a government employee retiring today after 30–34 years on the job receives an average annual pension benefit of \$43,020. In a small number of cases where CAFR data is unavailable, I estimate the benefits payable to new public retirees using salary data and benefit formulas available in pensions’ annual actuarial valuations.³ In one case, Nebraska’s cash balance plan, the estimated results should be treated with particular caution.⁴

Annual benefits for new retirees are reported in figure 1. In many cases, these benefits look far from modest. In California, for instance, average annual benefits for a

FIGURE 1

ANNUAL BENEFIT, FULL-CAREER RETIREE FROM STATE GOVERNMENTS



Source: Author's calculations from plan CAFRs and actuarial valuations.

full-career retiree reach \$61,560. Benefits in Connecticut and Colorado are comparable. In Nevada, typical benefits for a full-career state employee retiring today lead the nation at more than \$64,000. In all of the above states, with the exceptions of Colorado and Nevada, state employees also would receive Social Security retirement benefits.

But other states are stingier, such as Maine, where annual benefits for a full-career state employee barely top \$25,000. In Mississippi, a new retiree would not receive even \$15,000 per year. In the average state, annual public pensions for full-career retirees come in at \$36,131. Because larger states pay higher average benefits, the average individual receives somewhat higher benefits.

But these raw dollars do not tell the whole story. For one thing, the cost of living can differ significantly from state to state. Moreover, while most state employees are eligible for Social Security benefits, some are not. Finally, what matters most for policymakers is how pensions offered by the government compare to the options offered in the private sector, not how one state government compares to others.

For these reasons, I compared total retirement income for full-career state employees, including both pension benefits and Social Security retirement benefits, to the earnings of full-time, full-year employees in each state.⁵ Pension benefits are derived from plan CAFRs, and Social Security benefits are estimated using the Social Security Administration's (SSA's) simple benefits calculator based on state employees' final salaries preceding retirement. Data on earnings for full-time workers are derived from the Survey of Occupational Employment Statistics compiled by the Bureau of Labor Statistics. These include not merely mean earnings but also the distribution of earnings within the state.⁶

Figure 2 shows the results of these calculations. In the average state, an average full-career state government employee has a combined pension and Social Security income higher than 72 percent of full-time employees working in that state. At the bottom is Maine, where benefits to full-career employees exceed the earnings of 31 percent of full-time workers. Indiana and Massachusetts pay benefits exceeding 42 and 45 percent of salaries paid to full workers in those states. At the high end is Oregon, where an average full-career state employee retiring today has a benefit exceeding the earnings of 90 percent of full-time employees in the state. West Virginia trails slightly at 89 percent, with California and Nevada paying average full-career retirees benefits that

exceed 87 percent of the wages paid to full-time workers in those states.

These calculations may be conservative for two reasons. First, government retirees may have additional income sources, such as interest or dividend income from personal saving, that are not included. Second, most public retirees receive retiree health coverage, which is rarer and poorer in the public sector. For instance, California's own Department of Human Resources advertises that employees can expect to receive a half million dollars in health benefits over their retirement.⁷

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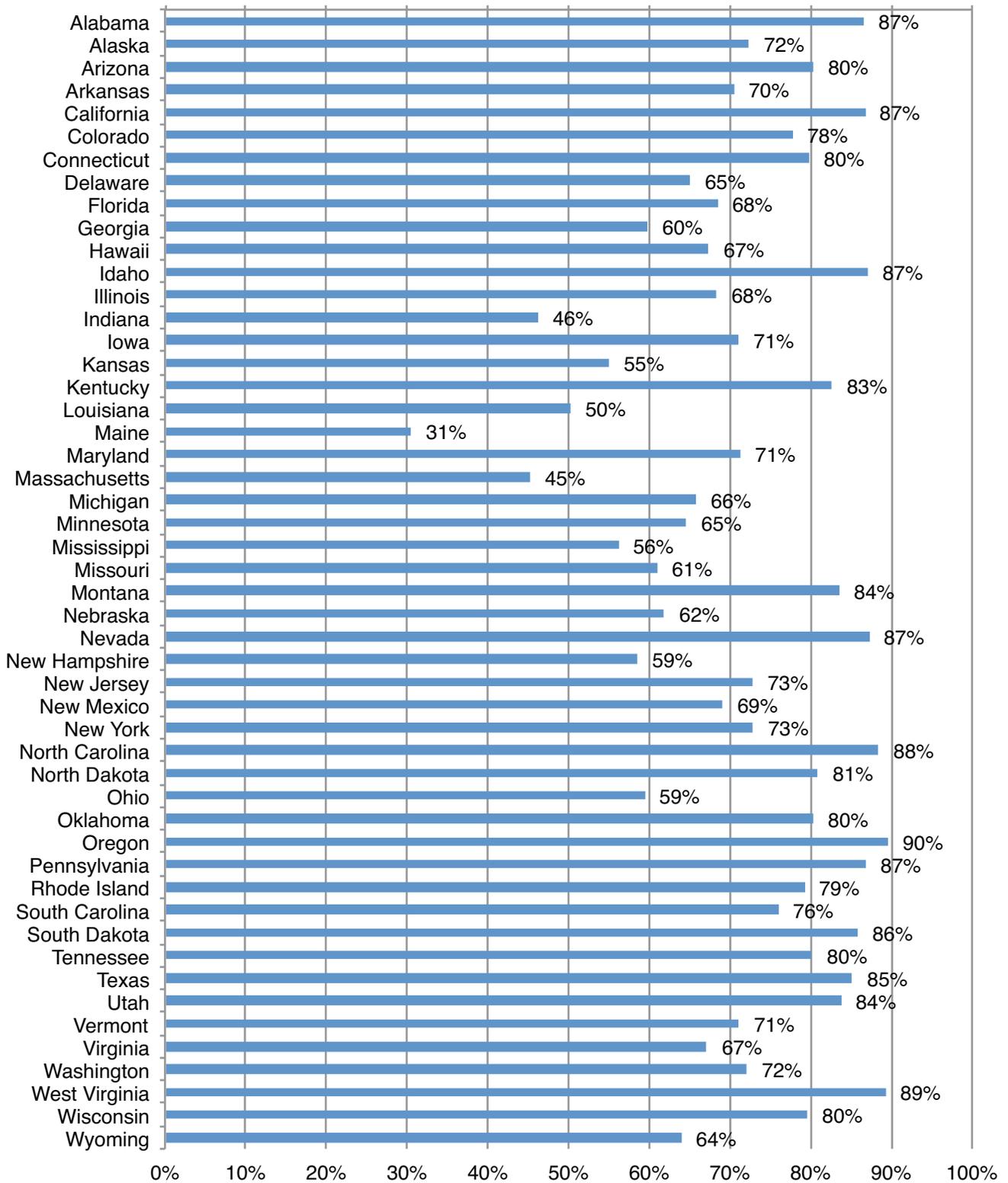
More broadly, retirees generally have a lower cost of living than working-age individuals, as mortgages may be paid off, children have left home, and there is little or no need to save for retirement. Thus, the standard of living of a retired full-career state government employee may exceed that of even higher percentages of working-age individuals in their state.

Pension Millionaires . . .

Another way to think about the value of public pension benefits is to consider total benefits paid out over an employee's retirement. From this point of view, many state retirement systems produce what might be called "pension millionaires"—that is, employees who will receive more than \$1 million in lifetime retirement benefits.

Figure 3 shows the present value of lifetime retirement benefits for full-career state government employees. Present value accounts for the fact that money can earn interest over time and thus can be represented as the lump sum balance, as of retirement age, that would produce the same pension benefits over the course of the worker's retirement. These figures assume that the average full-career employee retires at age 60 and survives until age 84.⁸ The pension plan is assumed to pay an annual cost-of-living adjustment (COLA) of 2.0 percent.⁹ Present values

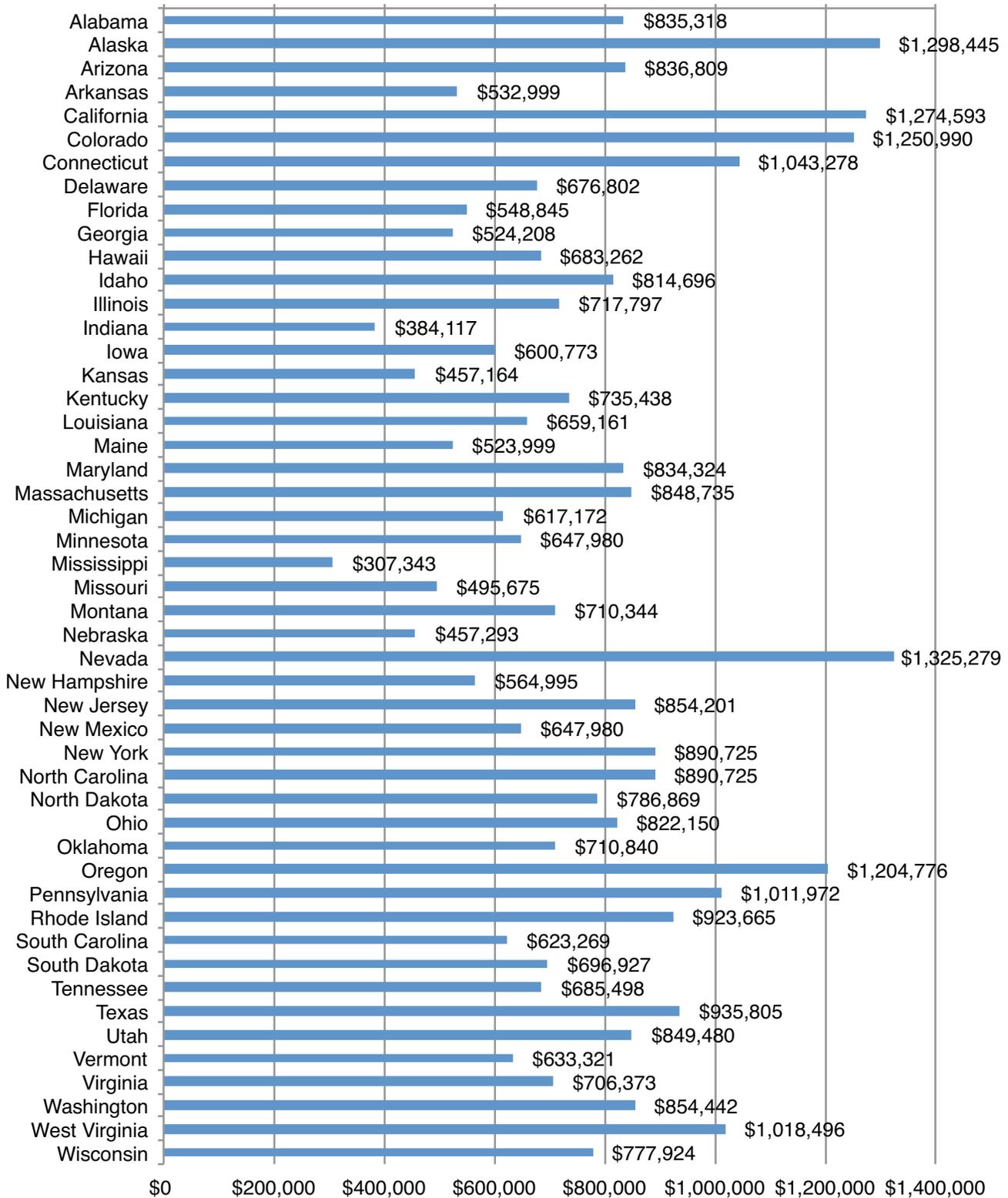
FIGURE 2
TOTAL RETIREMENT INCOME OF FULL-CAREER STATE EMPLOYEES AS PERCENTILE OF EARNINGS
FOR FULL-TIME WORKERS



Sources: Author's calculations using data from plan CAFRs and Survey of Occupational Employment Statistics (2012).

FIGURE 3

LIFETIME PENSION BENEFITS FOR FULL-CAREER STATE GOVERNMENT EMPLOYEES



Note: Assumes retirement at 60, survival to 85, 2.5 percent COLAs, and 3.5 percent discount rate.
 Source: Author's calculations based on pension CAFR data.

are calculated assuming an interest rate of 3.5 percent, based on current yields on long-term Treasury securities.

A full-career state government employee in the average state receives a lifetime retirement benefit with a present value of \$768,940. This means, for instance, that a worker who retires with a 401(k) balance of \$768,940 could provide for himself a retirement income similar to that received by a typical full-career state government employee.

Many state retirement systems produce what might be called “pension millionaires”—that is, employees who will receive more than \$1 million in lifetime retirement benefits.

Just as annual public pension benefits vary by state, so do lifetime benefits. The most-generous benefits are paid in Nevada, where the average full-career employee will receive more than \$1.3 million in pension benefits over the course of his retirement. In the four next most-generous states—Alaska, California, Colorado, and Oregon—lifetime benefits exceed \$1.2 million. A wealthy, high-cost state such as Connecticut offers a typical full-career employee more than \$1 million in lifetime benefits, but so does a relatively low-cost state such as West Virginia.

Even in the least-generous states, such as Mississippi and Indiana, a full-career state employee retires with pension benefits of more than \$300,000. Both states also offer Social Security to their employees, with employer and employee splitting the 12.4 percent payroll tax.

. . . And Pension Losers

Not every public employee will retire with these levels of benefits. In fact, one reason that public plans can offer such generous benefits to full-career employees is that short-term and partial-career workers often are treated particularly poorly. Two factors cause these inequities.

First, short-term employees may fail to vest, meaning that they are ineligible for benefits at retirement. Most public plans vest after about 5 years of service, although some require as many as 10 years before qualifying for benefits. Employees who leave government before

vesting may request a refund of their contributions, but they do not receive back their employer contribution or the interest earned on it. Researchers at Boston College estimate that “of those who leave state and local pension plans, 47 percent depart without any promise of future benefits.”¹⁰ In other words, full-career public employees receive high benefits not merely because public pension systems are expensive (although they are, relative to most private-sector pension plans) but also because shorter-term public employees receive so few benefits.

Second, simply vesting does not ensure a public employee a generous retirement benefit. Defined benefit (DB) pension benefit formulas are “backloaded,” meaning benefits are not earned proportionately to the employee’s years of service. Midtenure employees—those who work for a decade or so—receive disproportionately low benefits, while full-career employees receive disproportionately high benefits.

A recent report from the Maine Unified Retirement Plan Task Force pointed out that while a full-career employee would do reasonably well under Maine’s DB plan, only around one in five employees receive a benefit in excess of 50 percent of final earnings.¹¹ Employees who fail to work a full career fare far less than well than do full-career workers and, in many cases, would have done better under a DC pension plan.

For instance, an employee who retires from a typical public plan after 32 years on the job might receive a benefit equal to 68 percent of final earnings, close to the 70 to 80 percent replacement rate that financial advisers recommend. But an individual who works in government for half that time (16 years) and then shifts to a different job will not receive half that replacement rate, 34 percent of earnings. Rather, his replacement rate would be around 15 percent of earnings just before retirement, meaning that he must either save at extraordinary rates later in his career to meet the 70–80 percent recommended replacement rate or suffer from an inadequate retirement income.

Some pension reforms have proposed increasing vesting periods as a way to improve plan funding. But doing so makes public pensions even more inequitable. For instance, the Boston College researchers estimate that increasing vesting from 5 to 10 years reduces the probability that any given employee will become vested by around 16 percentage points.¹²

As a result of these policies, shorter-term public employees greatly subsidize the generous benefits received by full-career government workers.

It's Not Us; It's You

One response to data showing generous public pension benefits is obvious: it is not that public retirees are so well off, but that other retirees are barely getting by. Certainly that is the impression you might gain from the popular press, where many assume that Americans' retirement savings are wholly inadequate and concern over public employee retirement plans is little more than "pension envy." For instance, Nari Rhee estimates that 65 to 92 percent of Americans have insufficient savings to maintain their standards of living in retirement.¹³

But academic research tells a more nuanced story. For instance, Bruce Meyer of the University of Chicago and James Sullivan of Notre Dame use the Consumer Expenditure Survey to show that as few as 4 percent of current seniors consume goods and services worth less than the government poverty threshold.¹⁴ John Karl Scholz of the University of Wisconsin and his coauthors find that around three-quarters of near-retirees have adequate savings to maintain their lifestyle, concluding, "We see little . . . that leads us to think that households are making large, systematic errors in their financial preparation for preparation."¹⁵ Similarly, Michael Hurd and Susann Rohwedder of RAND find that around 71 percent of near-retirees are adequately prepared for retirement.¹⁶

My own work with Glenn Springstead of the SSA found that the typical new retiree in 2005 had an income exceeding his inflation-adjusted average preretirement earnings. The SSA's computer models project that future retirees will have somewhat lower replacement rates, but even then the typical household will have a total retirement income equal to its preretirement earnings.¹⁷

Public-plan advocates argue that reducing the generosity of pension benefits risks throwing retired government workers into means-tested welfare programs. Leaving aside that most pension reform plans would not affect the benefits of current workers, much less current retirees, these data show that benefits would need to drop substantially before long-term government employees risk becoming wards of the state.

Are Public Pension Benefits Excessive?

The pension benefits paid to full-career state government employees appear generous relative to private-sector pensions or to the earnings of working-age individuals

in their states. But from an individual financial planning standpoint, what matters is how retirement benefits compare to preretirement earnings. This relationship determines how well individuals can smooth consumption from work years through retirement, which is the goal of retirement saving.

Replacement rates, which measure retirement income as a percentage of preretirement earnings, are a crude tool that generally fails to account for marital status or whether the household contains children, both of which can significantly alter the target replacement rate an individual or couple should aim for.¹⁸ Nevertheless, replacement rate targets are widely used, with most financial advisers recommending a replacement rate of about 70, according to the SSA.¹⁹ A replacement rate below 70 percent does not necessarily mean that pension benefits paid by a state are inadequate, as it is not necessary that an employer-sponsored plan provide all the retirement income an individual might need.

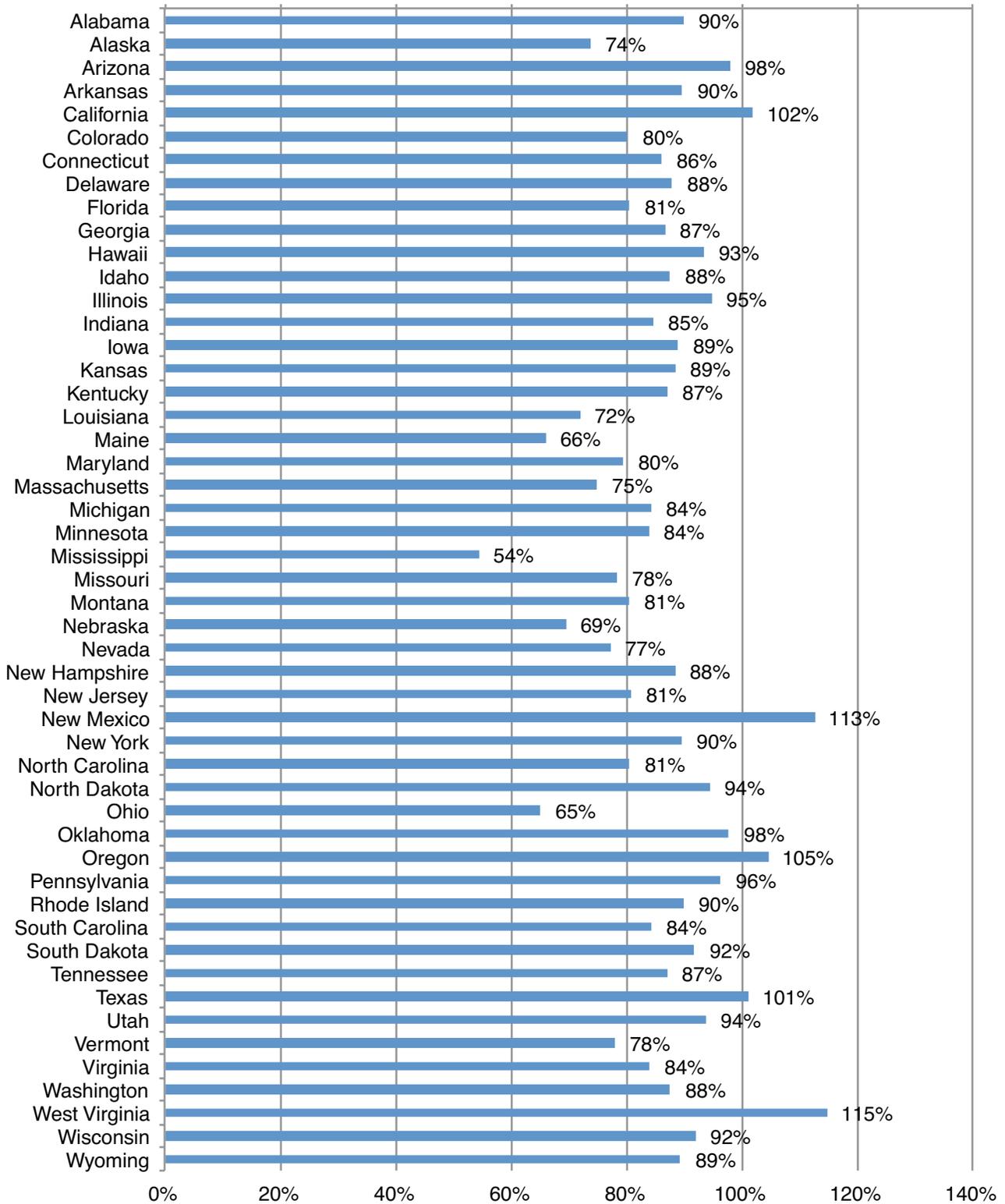
However, extremely *high* replacement rates might be indicative of public employees' "hiding" compensation in the form of pension benefits. Glaeser and Ponzetto (2013) argue that pension costs are "shrouded" from public view, allowing public employees to receive additional compensation that is difficult for voters to monitor.²⁰ We might infer that compensation is being hidden in pensions if replacement rates significantly exceed common targets, since rational individuals might otherwise prefer to trade lower retirement benefits for higher wages during their working years.

Replacement rates for full-career state government employees are calculated as the sum of DB pension benefits and Social Security benefits (where payable), as a percentage of earnings immediately preceding retirement. In most cases, final earnings are reported in CAFRs, though in a number of cases they are obtained from actuarial reports or are estimated based upon benefit amounts and the provisions of plan benefit formulas. (See figure 4.)

The replacement paid to a full-career employee by the average state government is 87 percent of final earnings. Such workers exceed financial advisers' recommended replacement rates by a comfortable, though not implausibly large, threshold. While subject to individual judgment, an average replacement rate in excess of 90 percent might be considered a threshold worthy of attention; many individuals, particularly those who had children at home during their working years, might find this level to be excessive.

FIGURE 4

TOTAL RETIREMENT INCOME REPLACEMENT RATES FOR FULL-CAREER STATE GOVERNMENT EMPLOYEES



Source: Author's calculations based on plan CAFRs and other data.

The lowest replacement rate is 54 percent of final earnings, in Mississippi. Fourteen states have total replacement rates between 90 and 100 percent of preretirement earnings. Three states (Oregon, California and Texas) pay total retirement benefits between 100 and 110 percent of final earnings. New Mexico and West Virginia pay the highest replacement rates, with combined pension and Social Security benefits equal to 113 and 115 percent of final earnings, respectively.

What Should We Do?

Pension reforms should resolve two sets of inequities: between public- and private-sector employees, and between short- and long-career public employees.

First, overall benefit levels for public pensions should be made more comparable to those in the private sector. In some cases, higher pension benefits may merely compensate for salaries those paid to similarly skilled private-sector workers. However, it appears that in a number of states more-generous pension benefits are sufficient to push overall public-sector compensation well above private-sector levels.²¹

At the least, public pension benefits should be more transparent. One step is the adoption of “market valuation” of DB pension liabilities, an approach that better captures the full cost of such benefits to the government and their full value to employees.²² More transparent still would be to shift public employees to DC pensions, in which the employer contribution is easily understandable and directly comparable between public- and private-sector occupations.

Second, public employee plans should provide more equity between employees of different career lengths. The typical final-earnings DB plan is heavily weighted toward full-career workers, at the cost of reducing benefits and retirement security for shorter-tenure employees. Several approaches could address this.

First, benefits could be calculated based on career earnings rather than final wages. Social Security already does this, using adjustments to account for inflation and the growth of wages over time.

Second, public employers could shift to DC or cash balance plans, both of which generate benefits based upon lifetime earnings and contributions. The evidence that DB plans serve strong human resources needs, in attracting and retaining valued employees, is far weaker than public plans contend.²³ Indeed, some research

shows that a cash-balance pension plan could improve employee retention.²⁴ Thus, improving equity between short- and long-career workers would not impose a significant cost on governments.

Public employees are likely more risk averse than private-sector workers and so may desire a different and less risky type of pension. Likewise, governments may find that different pension structures better suit their needs in attracting and retaining employees. But different pensions for public employees need not imply public pensions that are many times more generous than those paid to the private-sector workers whose taxes keep public plans running.

Many public plans have already instituted lower benefits for new hires, and more are considering such reforms. But it would be rare to find any full-career public employee who would receive a more generous pension in a private-sector job. Public employees should be willing to accept—and private-sector workers to demand—more equity in the generosity of their pension plans.

About the Author

Andrew G. Biggs is a resident scholar at the American Enterprise Institute.

Notes

1. American Federation of State, County, and Municipal Employees, “AFSCME Facts: The Truth about Public Service Workers’ Pensions,” www.afscme.org/issues/pension-security/resources/document/AFSCME-FactSheet_Pensions.pdf.

2. These are the most recent years for which data are available.

3. These states include Rhode Island, North Carolina, Florida, Kentucky, Massachusetts, Vermont, New Jersey, Connecticut, and Nebraska.

4. A cash balance plan pays participants a guaranteed rate of return on employer and employee contributions to a notional retirement account. It is classified as a defined benefit plan, as it pays benefits according to a formula, but like a defined contribution pension, it provides a portable benefit based upon lifetime rather than final earnings. Data on Nebraska are sparse for two reasons. First, Nebraska does not publish a CAFR similar to other states, meaning that benefit figures produced from plan data are unavailable. To estimate benefits, I converted the average account balance for near-retirees into a monthly benefit using an annuity calculator on the Nebraska Public Employee Retirement System website. More

important, however, is that Nebraska's cash balance plan has been in place since only 2003 and was mandatory for only newly hired employees. Current employees at the time had the option to shift assets from the existing defined-contribution pension plan into the new cash balance program, but it is not clear which employees did so and to what degree they did. For these reasons, the figures for Nebraska are far less certain than those for other states.

5. Ideally we would compare the retirement income of state government employees to the incomes of other retirees within their state. However, common data sets such as the Current Population Survey and American Community Survey understate the income derived from defined contribution pensions such as IRA and 401(k) plans, which are particularly common among private-sector employees. For this reason, a comparison to retiree income might overstate the relative incomes of public employees, who rely disproportionately on defined benefit pension plans. See Sylvester Schieber and Andrew G. Biggs, "Retirees Aren't Headed for the Poor House," *Wall Street Journal*, January 24, 2014.

6. For each state, the OES data set provides earnings levels at the 10th, 25th, 50th, 75th, and 90th percentiles of the distribution. I fit a curve to these data points, then use that formula to estimate the percentile of the state earnings distribution at which a state employee's retirement income lies.

7. California Department of Personnel Administration, "Total Compensation Survey—Benefits," 2010, www.dpa.ca.gov/tcs2006/benefits.htm#retirement (page no longer live).

8. While each system is different, these assumptions are fairly typical. For instance, see CalPERS Actuarial Office, "CalPERS Experience Study: 1997 to 2007," April 2010.

9. In reality, some plans offer higher COLAs than others; in many plans COLAs are ad hoc or contingent upon inflation in a given year. Thus, a 2.0 percent COLA assumption is a simplification. The Public Fund Survey has a summary of the COLA provisions for a large number of public plans. See www.publicfundsurvey.org.

10. Alicia H. Munnell et al., "The Impact of Long Vesting Periods on State and Local Workers," *State and Local Pension Plans Issue in Brief*, no. 26 (2012).

11. Maine Unified Retirement Plan Task Force, *Task Force Study and Report, Maine State Employee and Teacher Unified Retirement Plan*, March 8, 2010, www.maineperc.org/PDFs/other%20publications/MainePERS%20Final%20URP%20Task%20Force%20Report%203-9-2010.pdf.

12. Munnell et al., "The Impact of Long Vesting Periods."

13. Nari Rhee, *The Retirement Savings Crisis: Is It Worse Than We Think?* National Institute on Retirement Security, June 2013.

14. Bruce D. Meyer and James Xavier Sullivan, *Consumption and Income Poverty for Those 65 and Over* (Chicago: University of Chicago Harris School of Public Policy, 2007).

15. John Karl Scholz, Ananth Seshadri, and William Gale, "Are All Americans Saving 'Optimally' for Retirement?" report for the US Social Security Administration as part of the Retirement Research Consortium, December 31, 2009.

16. Michael D. Hurd and Susann Rohwedder, "Economic Preparation for Retirement," in *Investigations in the Economics of Aging*, ed. David A. Wise (Chicago: National Bureau of Economic Research and University of Chicago Press, 2012), 77–113.

17. Glenn Springstead and Andrew Biggs, "Alternate Measures of Replacement Rates for Social Security Benefits and Retirement Income," *Social Security Bulletin* 68, no. 2 (2008), www.ssa.gov/policy/docs/ssb/v68n2/v68n2p1.html.

18. See Andrew G. Biggs, "Will You Have Enough to Retire On?: The Retirement Security 'Crisis,'" *AEI Retirement Policy Outlook*, no. 2 (February 2009), www.aei.org/outlook/economics/retirement/will-you-have-enough-to-retire-on/.

19. "Social Security Retirement Planner: Plan for Your Retirement," Social Security Administration, www.ssa.gov/retire2.

20. Edward L. Glaeser and Giacomo A. M. Ponzetto, "Shrouded Costs of Government: The Political Economy of State and Local Public Pensions" (working paper no. w18976, National Bureau of Economic Research, Cambridge, MA, 2013).

21. See Andrew G. Biggs and Jason Richwine, "State-by-State: A National Survey of Government Employee Compensation" (forthcoming AEI working paper) for analysis of state government employee pay and benefits.

22. Andrew G. Biggs, "An Options Pricing Method for Calculating the Market Price of Public Sector Pension Liabilities," *Public Budgeting & Finance* 31, no. 3 (2011): 94–118.

23. See Robert M. Costrell and Michael Podgursky, "Peaks, Cliffs, and Valleys: The Peculiar Incentives in Teacher Retirement Systems and Their Consequences for School Staffing," *Education Finance and Policy* 4, no. 2 (2009): 175–211.

24. Robert M. Costrell and Josh B. McGee, "Teacher Pension Incentives, Retirement Behavior, and Potential for Reform in Arkansas," *Education* 5, no. 4 (2010): 492–518.