State Pensions in Changing Times

by Richard Woodbury
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With the age distribution of the population bulging around older age groups, financial pressure is increasing on nearly all retirement-income programs. The pressure is motivating policy reexamination and reform in, for example, the private sector's employer-provided pensions, Social Security, state and local pension plans, and retirement-income programs outside the country. Given the topic's importance, this author conducted a study, specifically on the impact that demographic changes were having on the pension plans for state employees in New England.[1]

How State Pension Plans Work

All New England states offer traditional defined-benefit pension plans to state employees. Under defined-benefit plans, an employee's pension entitlement consists of continuing salary-like payments through the post-retirement years. The amount is based on the employee's preretirement salary, years of service, and retirement age.

As illustration, Maine's benefit formula provides for "normal retirement" beginning at age 62 with a pension that is 2 percent of the employee's final average salary per year of service. A full-career employee hired at age 22 would have 40 years of service at age 62 and could retire with a pension equal to 80 percent of her preretirement salary, in this case averaged over the highest three years. An employee hired at age 40 would have 22 years of service at age 62 and could retire with a pension equal to 44 percent of his previous salary. An employee hired at age 50 would be eligible for a 24 percent pension at age 62. Once retired, the pension rate is inflation-adjusted annually and continues for the retiree's lifetime. Life expectancy at age 62 is 19 years for men and 22 years for women.

Although the general structure is similar across the New England states and across the multiple plans within states, there is variation in the benefit amounts, the ages of eligibility, the adjustment factors for retiring at different ages, and so on. For long-service employees in particular, pension payments

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can be substantial, and the eligibility age for retirement young.

The full-career employee hired at age 22, for example, is eligible for "normal retirement" at age 55 in Vermont, age 60 in both Connecticut and New Hampshire, age 61 in Massachusetts, and age 62 in Maine and Rhode Island. By age 62, a full-career employee would have accrued an annual pension benefit of 55 percent in Connecticut (the percentage of preretirement salary), 60 percent in Vermont, 61 percent in New Hampshire (67 percent before age 65), 75 percent in Rhode Island, and 80 percent in Maine and Massachusetts.

The benefits are proportionately smaller for employees who do not spend their full careers in state employment. For an employee hired at age 40, for example, workers taking normal retirement would receive 29 percent of salary beginning at age 62 in Connecticut, 40 percent at age 64 in Vermont, 44 percent at age 65 in Rhode Island, 44 percent at age 62 in Maine, and 63 percent at age 65 in Massachusetts.

Importantly, the higher-benefit plans in Maine and Massachusetts are substitutes for Social Security, rather than supplements. No Social Security taxes are paid, and no benefits are accrued from state employment in either plan. (If these state workers earn money from additional jobs, the associated Social Security benefits may be reduced by the Government Pension Offset and Windfall Elimination Provisions of Social Security.) In Connecticut, New Hampshire, Rhode Island, and Vermont, the state pension benefit is in addition to Social Security.

The Demographic Pressures

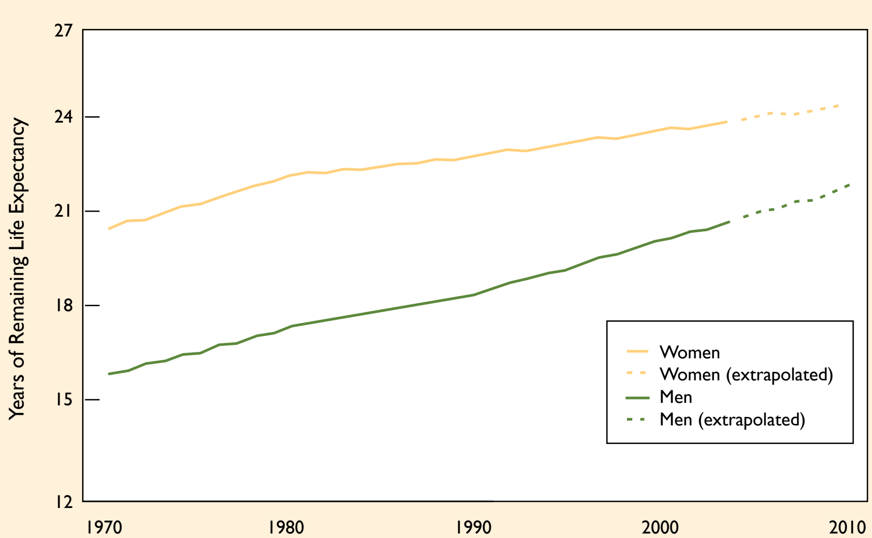
The pressure on state pension programs is a result of both financial and demographic factors. The financial factors include historical underfunding, recent financial market declines, and strained economic conditions. Most pension plans are substantially underfunded relative to the benefit obligations that plan participants have accrued. The demographic factors include increased individual life expectancy and the baby-boom generation's move into retirement ages.

What distinguishes the next 20 years is the position of the baby-boom generation (born between 1946 and 1964) in the population's age profile. Right now, most baby boomers are still in the prime of their working careers: earning income, paying taxes, contributing to retirement systems, and partially supporting a comparatively smaller population of older retirees. But in 20 years, most boomers will be drawing retirement benefits themselves. This is the essence of the unfunded liabilities that will come due. (See "New England Adult Population Projections.")

According to U.S. Census Bureau projections, New England's younger working-age population (age 21-44) is projected to *decline* by 1 percent by 2030, the more established working-age population (age 45-64) is projected to *decline* by 11 percent, and the senior population (age 65+) is projected to *grow* by 65 percent.[2]

Trends in life expectancy compound the demographic impact of the baby-boom generation.[3] (See "Years of Remaining Life Expectancy.") Cumulatively, the life expectancy of 60-year-old men rose from 16 years in 1970 to nearly 21 years in 2004. The life expectancy of 60-year-old women rose from 20.6 years in 1970 to 24 years in 2004. These trends equate to an increase in life expectancy at age 60 of one to two months every year, a trend showing no sign of changing.

Years of Remaining Life Expectancy at Age 60 in the United States



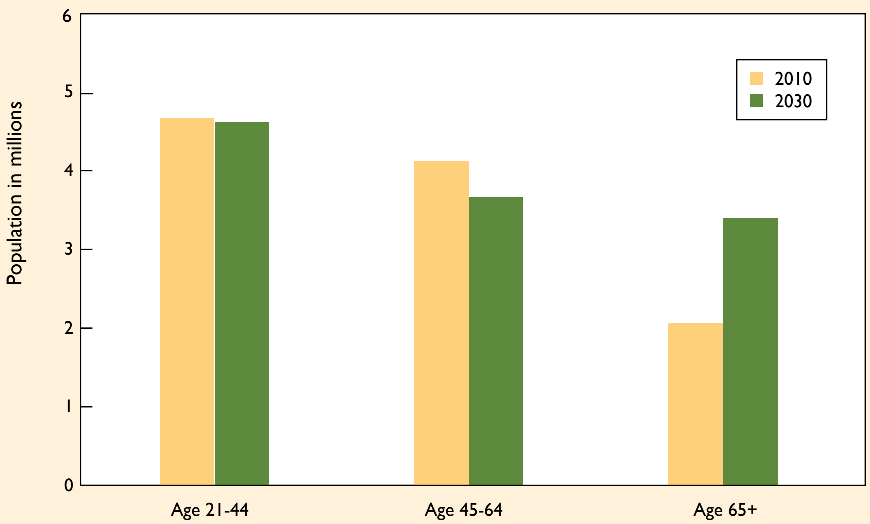
Source: National Center for Health Statistics. Extrapolations by author.

Demographics and Reform

In confronting state pension systems' funding challenges, it is important to differentiate among (1) the unfunded liability for benefits that have already been accrued, (2) the newly accrued benefits being earned by currently participating workers going forward, and (3) the pension system one would design for newly hired workers, based on current population demographics and life expectancies. Legal and moral obligations will prevent any major reduction in the benefits that employees have already accrued from past work. More substantive reforms to pension systems can be imposed going forward.

Many categories of reform have been proposed, and in some states, enacted. These reforms may include increased employee contributions, reduced benefit rates, shifts from traditional pension plans to defined-contribution systems, reintegration with Social Security, redefinition of the salary base on which benefits are determined, limits on the inflation adjustment of benefits, older eligibility ages for early or normal retirement, or more steeply reduced benefits

New England Adult Population Projections by Age Category
2010 and 2030



Source: U.S. Census Bureau

for those choosing early retirement.

A particular consequence of increasing longevity is the lengthening period over which pension benefits are being paid. This motivates reforms that move back the eligibility ages for benefits to reflect rising life expectancy. Social Security is phasing in its own increase—moving the normal retirement age from 65 to 67—and could go further.

What duration of later life should pension systems be structured to support? What is the average number of years that pension benefits will be paid to retiring workers? (See "Expected Number of Years of Pension Benefits.") If pension benefits begin at age 55, for example, states will pay them for an average of 25 years for men and 28 years for women. If pension benefits begin at age 62, states can expect to pay them for 19 years for men and 22 years for women. If benefits begin at age 70, states will pay them for an average of 14 years for men and 16 years for women.

Other approaches make policies more flexible to retirement at any age. The shift to age-neutral policies has already occurred in much of the private sector, where savings-based retirement systems such as 401(k) plans have largely replaced defined-benefit plans. What is generally lost in these plans is the annuitized payment stream of traditional pensions and their implicit insurance against outliving one's resources.

Defined-benefit pension plans can be reformed to be age-neutral by making actuarially fair adjustments in the benefit amount for retiring at different ages. Under that approach, the discounted cost of the payment stream is calibrated to be the same, regardless of when the payments begin. So if an employee starts claiming a benefit a year earlier, for example, the payment rate is reduced by an amount that compensates for the additional year the employee would receive the payments. Similarly, if an employee delays retirement, the payment rate rises to reflect its shorter duration.

Whatever reforms are implemented, a critical consideration is the changing demographic context in which pension systems operate. People are living longer and healthier lives. For new employees in particular, the challenge is designing a pension system that reflects current demographics, health, life expectancy, and workforce objectives going forward.

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Endnotes

1 Richard Woodbury, "Population Aging and State Pensions in New England" (NEPPC research report 10-1, Federal Reserve Bank of Boston, June 2010).

2 U.S. Census Bureau, "State Interim Population Projections by Age and Sex: 2004 - 2030," www.census.gov/population/www/projections/projectionsagesex.html.

3 Author extrapolations of National Center for Health Statistics, U.S. Centers for Disease Control and Prevention, "United States Life Tables, 2004," www.cdc.gov/nchs/data/nvsr/nvsr56/nvsr56_09.pdf.

Expected Number of Years of Pension Benefits Based on Retirement Age, 2004