THE JOSIAH BARTLETT CENTER FOR PUBLIC POLICY

POLICY MATTERS

Using Information and Ideas to Transform Public Policy

Defined Contribution Models in Other States

Joshua Elliott-Traficante

With mounting unfunded liabilities in their pension systems, made worse by the recent economic turmoil, many states have begun looking at other retirement benefit options. In recent years, policy makers in a number of states have turned away from the pure pension model, instead opting for plans that are not only fair to the employees but also free the taxpayers from being left with the bill for huge deficits. Given the scale of the pension funding crisis, several reform minded states have instituted a variety of systems to replace their pension systems, which are outlined in the following paper.

Pure Defined Contribution System:[i]

A pure defined contribution system functions in the same way as a private sector 401(k) does. However, rather than having employee contributions matched by the employer up to a certain percentage of salary, state plans tend to fix the contribution rates, similar to a defined benefit plan. Under a defined contribution plan, all of the risks and rewards of the investments are placed with the employee. Due to this shift in risk from the employer to the employee, there will never be an unfunded liability under a defined contribution system because there are no liabilities other than the initial contribution by employers.

States with mandatory defined contribution systems:
Alaska, The District of Columbia, Michigan (state employees), Utah (must choose between defined contribution plan or Hybrid plan)

States with open optional defined contribution systems:
Florida, Montana, Colorado, Ohio (all but Police &Fire), South Carolina (all but Police &Fire), North Dakota (non-classified employees)

Member Direction?

In all of the states offering defined contribution plans, the employees have a say in the investment direction. For the most part, employees do not get to pick what particular stocks or bonds to buy, as they would with a brokerage account. Instead they pick the fund or a blend of funds. Most states offer a selection of funds for their employees to choose from ranging from Target Date Funds to Treasury Bond funds and everything in between.[ii] Utah offers in addition to different funds, blends of funds that offer varied risk. Alaska stands out in that in addition to the funds they offer, they offer brokerage accounts for its members, allowing them to pick individual stocks. Given the risks involved, employees must choose to opt into this plan.[iii]

Variations: In House vs. Contracted Out

When discussing the possible implementation of a defined contribution system, the question invariably rises of whether to manage the assets of these plans in house, or let an outside investment company manage the funds. Both options are currently being exercised. In Alaska, Michigan and Washington DC, plan assets are managed by number of firms including Black Rock, T Rowe Price and State Street Global Advisors while in Utah the assets are managed in house by the state's retirement system.

Important Consideration: Social Security

No two states are exactly alike, so simply taking what one state has done and doing it here in New Hampshire, without modification, would be ill-advised. For New Hampshire to switch over to a defined contribution system, changes might need to be made to Group II (Police and Fire) to ensure equity between the two groups. Currently Group I employees pay into Social Security while working and receive benefits when they retire. It functions similarly to a pension plan in that it provides a regular and guaranteed payment. Group II however, neither pays into, nor receives Social Security. (In part this is why they pay higher contribution rates.) In order to give Group II retirees the same assurances their Group I counter parts have, there are two potential options, either require new Group II members to enroll in Social Security or create a version of a Hybrid Plan, which combines a pension and a 401k scheme that is only open to Group II. Below are the Social Security policies of the states that have mandatory defined contribution plans.

Social Security Participation:[iv]
Alaska: State employees (including State Police) <u>do not</u> participate
Washington DC: Police and Fire <u>do not</u> participate
Michigan: State Employees <u>do</u> participate

Contribution Rates:
Alaska: (Fixed) Employer 5% / Employee: 8%
Utah: (Fixed) Employer: 10%-12%/ 0% (Employees can contribute but it is unmatched)
Washington DC: (Fixed) Employer: 5%-5.5%/ Employee contributions prohibited.
Michigan: Employer: Mandatory 4%; Match additional 3%, Total Max 7%/ Employee: 100% employer match, on first 3%

The Hybrid System:

A Hybrid System combines a reduced pension and with a supplemental 401(k) for retirement benefits. The idea, similar to that of Social Security, is to give retired state employees some sense of stability in their retirement income, while at the same time not burdening the taxpayers with large pension liabilities. The funding mechanisms vary from state to state.

Under Utah's Hybrid System, the employer's contribution total 10% (12% for Public Safety) of the salary of the employee. This contribution is then divided between a pension fund and a

401(k) fund. Each year the contribution rate for the pension portion is assessed. For the 2011-2012 year, this rate was calculated by the actuaries to be 7.59%. The remaining 2.41% was contributed to the 401(k) portion.[v] There is no mandatory employee contribution; however if the pension portion costs exceed 10%, then the employee must cover the difference.

The Utah model is only one way for a Hybrid model to function. Under Georgia's plan, the employee pays 1.25% towards the pension portion and the state contributes a portion set by actuaries (7.42% for 2011-2012 year). The employee also contributes mandatory 1% to the 401(k) plan, with the state matching 100% for the first 1% and 50% for the next 4%. In simpler terms, the state's maximum contribution to the 401(k) portion is 3%[vi]

States with mandatory Hybrid systems: Georgia, Washington State (Teachers), Michigan (Teachers)

States with open optional Hybrid systems: Ohio, Oregon, Indiana, Washington State (All but Teachers), Utah (must choose between defined contribution plan or Hybrid plan.

Points worth considering:

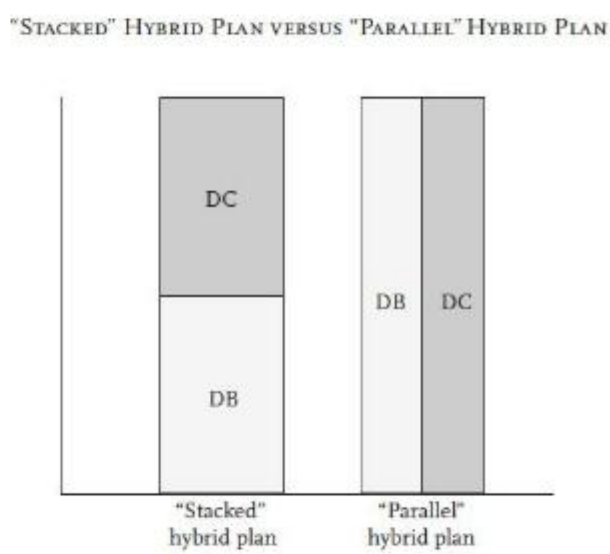
- Investment risk spread between tax payers and employees
- Combination of potential greater return and stability
- Taxpayers still liable for short falls, albeit smaller than normal pension plan

Variations: COLAs

It is important to note that the contribution rates for Utah take into account cost of living increases (COLA) to the pension portion that are based on the Consumer Price Index. COLAs are capped at 2.5% per year. This model is the exception to the norm. COLAs in the Georgia plan are at the discretion of the retirement board but not specifically built into the plan, other state plans, such as Michigan's, prohibit them.

Variations: Institutional vs. Member Direction:

For the 401(k) portion of the hybrid plans, states have taken different routes in terms of who dictates the direction of the investments. In Utah, Oregon and Georgia, for example, all of the investment direction is done in house by the respective retirement systems. In contrast, Ohio's system allows for employees to choose between different in house managed funds.[vii]



Variations: Parallel Hybrid vs. Stacked Hybrid[viii]

Parallel Hybrid: This is the type of hybrid plan now in effect for the all of the states mentioned above. The employee receives a split DC/DB plan at all income levels. Though pensions would be smaller in comparison to a pure defined benefit plan, there is no cap.

Stacked Hybrid:[ix]

This type of plan, proposed by the Center for Retirement Research at Boston College, flips the parallel hybrid plan on its side. Rather than a split plan at all income levels, an employee is given a pension, based on a capped salary, for the sake of argument, $40,000. For those who make less than this amount, they and the employer only make contributions for a pension. For those who make more, say $60,000, the employees and employers would make contributions to the pension portion on the first $40,000, while any contributions made on salary over that amount would be placed into a 401(k).

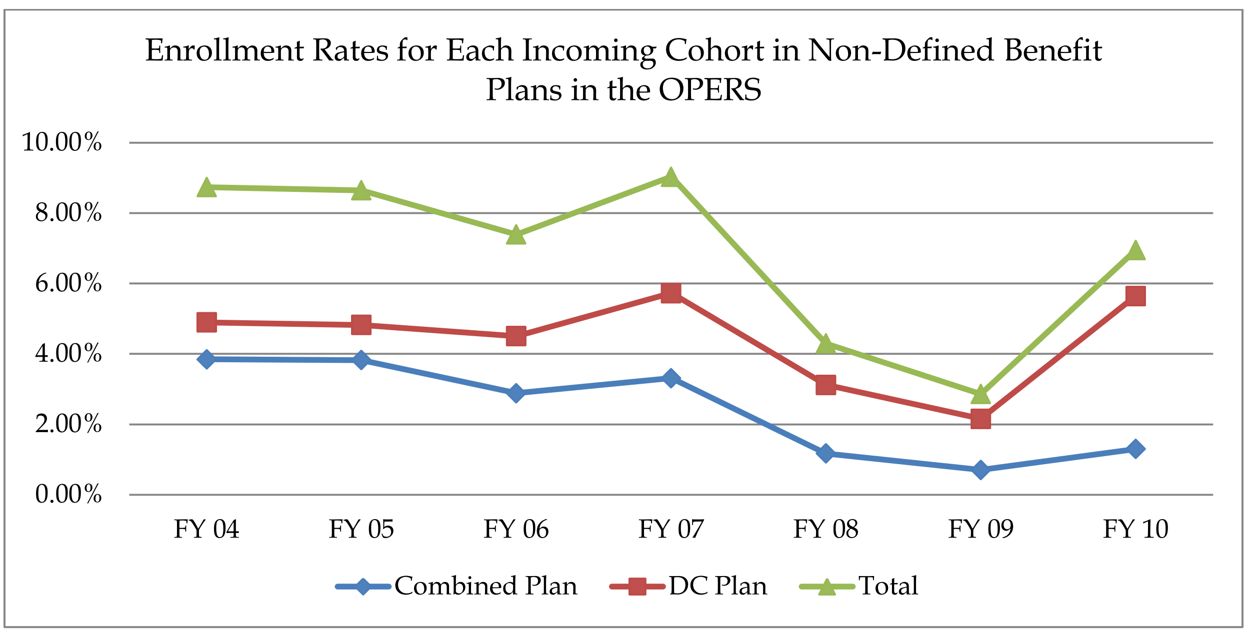
Implementations and Important Considerations:

In the case of the stacked hybrid plan, suggested as an alternative to the parallel plan, what the cap is on the pension can vary. The proponents of the plan at the Center for Retirement Studies at Boston College proposed having the cap set at the average salary for the resident of the state, which is then indexed to inflation.[x] This cap could be set at any level, average state salary, median state salary, or just a round number, like $40,000, which is then indexed in some way to the growth of inflation so as to retain its intended value.

"All of the Above": Ohio's Plan

Ohio offers the greatest variety of choices to their public employees in terms of retirement plans. Under the Ohio Public Employee Retirement System (OPERS) employees are given the option of joining a traditional defined benefit plan, a hybrid plan, or a defined contribution plan. With the employee contribution rates the same across the three plans, there is no upfront financial incentive for an incoming employee to choose one over another.

Enrollment Data:[xi]



It remains to be seen what these statistics will look like once the stock markets recover, so FY 11 and FY 12 data will be prove to be crucial in examining long term trends. That being said however the take away point of this data is that there is at least some demand for a defined contribution or hybrid option among state employees. However, it should be noted that the defined benefit option is the default option for new hires that along with its generosity, skews the numbers in favor of that plan.

In contrast to Ohio's experience, initial enrollment figures have been coming from Utah which shows that by a 60% to 40% margin, when given the choice between a pure defined contribution plan and a hybrid plan, employees are choosing the defined contribution plan by a large margin. It should be noted that the default option for employees in Utah is the hybrid plan.

Conclusion:

While it remains to be seen the exact plan the study committee tasked with examining different defined contribution plans suggests, what is clear is this: other states have defined contribution plans, some even dating back to the 1990s; it is possible for a state to close their pension plan and open a new hybrid or defined contribution plan and it is possible to accomplish this without incurring massive transition costs, otherwise no state would have made the switch.

A subsequent paper will be released later this autumn examining the transition costs and the issues surrounding the remaining unfunded liability.

---

[i] The contribution rates and ratios between the 401(k) and pension portion of the hybrid plans expounded on in this paper should not be taken as specific policy suggestions; they have been merely used to illustrate how other states administer similar systems.
[ii] http://doa.alaska.gov/drb/dcrp/financial/dcrp-investment-options.html
[iii] http://doa.alaska.gov/drb/pdf/dcrp/dcrplansummary.pdf
[iv] http://www.nasra.org/resources/CRS%202011%20Report.pdf
[v] https://www.urs.org/pdf/AnnualReport/2010/annualReport.pdf
[vi] http://www.ers.ga.gov/plans/ers/formspubs/GA%20ERS%206-30-2009%20Valuation%20Report%20Final.pdf
[vii] https://www.opers.org/members/combined/index.shtml
[viii] Image taken from "A Role for Defined Contribution Plans in the Public Sector" released by the Center for Retirement Research at Boston College.
[ix] http://crr.bc.edu/briefs/a_role_for_defined_contribution_plans_in_the_public_sector.html
[x] http://crr.bc.edu/briefs/a_role_for_defined_contribution_plans_in_the_public_sector.html
[xi] *Chart Notes*: The option for new employees to choose between the three plans was first available in FY03, however the data is not available for that year to determine the enrollment rates in the various plans by the incoming cohort. 100%-Total= Traditional Pension Enrollment