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Cash Balance Plan Likely to Increase Costs, Impact the Quality of Public Services and Reduce Retirement Security

By Jason Bailey

While the primary pension challenge Kentucky faces is how to find the revenue to pay back the existing unfunded liability, much of the attention has instead focused on moving new employees to a defined contribution plan or a hybrid plan like the cash balance option included in Senate Bill 2. However, there are a number of reasons to prefer Kentucky’s existing defined benefit design over such a plan.

Here, we outline the potential impacts of a cash balance plan on state costs and on Kentucky’s ability to attract a qualified workforce and provide retirement security for workers.

Cash balance plan may be more expensive than the existing plan for new employees.

The cash balance plan in Senate Bill 2 may make Kentucky’s pension funding challenge even worse. Analysis of the actuarial statement for the legislation shows that the cash balance plan is projected to increase state costs by $55 million over the next 20 years compared to keeping the existing defined benefit plan for new employees.¹

In fact, additional costs may be even greater than that for several reasons. The actuarial analysis notes that the system’s assumed rate of return of 7.75 percent was used to develop the cost projections. However, the actuary’s model predicted that the cash balance plan would likely credit individual accounts at a higher rate, with a median estimate of 8.1 percent. The analysis notes that “to the extent the actual credit rate is higher than 7.75 percent, the costs of the legislation will be greater than shown in the enclosed tables.”

Unpredictable and potentially higher costs are a concern with cash balance plans. In the case of the Wisconsin Energy Corporation, a cash balance plan with a design similar to Senate Bill 2’s plan failed because it ended up being considerably more expensive than originally estimated.² Cash balance plans like proposed in Senate Bill 2 can raise costs because while the state must make up for shortfalls in investment returns below four percent, the system benefits from only 25 percent of investment returns above that amount. Under the existing defined benefit system, all returns above the anticipated rate of 7.75 percent are banked by the system to help make up for periods of lower returns.

The state will also face additional costs because of the expected increase in employee turnover under a cash balance plan. Cash balance plans don’t reward long-term employees like traditional defined benefit plans, increasing the likelihood that workers will leave earlier in their careers. Greater employee churn and a less experienced workforce will mean more money spent on hiring, recruitment and training.
The cash balance plan is also said to reduce risk to the state. But as mentioned above, the design of the plan means that it shares investment risk differently, but not necessarily in a way that will reduce state costs. Traditional defined benefit pension plans are actually well-designed to take on investment risk and absorb fluctuations in the market. They only disburse a small portion of their assets each year and can therefore operate with a long-term time horizon. Individual workers, however, are poorly-suited to take on that risk.

The possibility of poor investment returns is not the biggest risk Kentucky’s pension system faces, nor the reason Kentucky got into its serious situation. The retirement system’s losses in the recent recession were on par with other states, yet the financial status of most states’ pension systems will return to adequate levels in the next few years. Those states with plans in very poor condition, like Kentucky, Illinois and New Jersey, got into that position because they underfunded promised benefits.

The biggest risk Kentucky faces is that the state won’t make its annual required contributions (and pay for cost-of-living adjustments) in the future. The cash balance plan doesn’t change that, because accrued benefits will still be a legally-protected obligation of the state (as they should be). There are ways to lower the risk of state underfunding while continuing to provide the retirement security of a traditional defined benefit plan. But they involve creating a financial plan and mechanisms that ensure regular and responsible funding in the future, not switching to a new, untested, and likely more expensive plan.

Senate Bill 2 includes a vague statement of intent around paying the full required contribution each year, but it misses the point by not identifying the source of funding. Everyone knows the state should make the full contribution each year, but it hasn’t done so for 14 of the last 21 years.

**Cash balance plan could harm state’s ability to attract and retain a skilled workforce needed to deliver quality public services.**

A cash balance plan would have a negative impact on the public sector’s ability to attract a qualified workforce. The security and predictability of a guaranteed defined benefit plan is a major recruitment tool for the public sector. This incentive is particularly important to attracting high-skilled employees like engineers, health care professionals, lawyers and computer programmers who have good-paying options in the private sector and who make up a sizeable share of the public sector workforce. And for less-skilled workers, a secure pension reduces the likelihood that they and their families will fall into poverty in old age and require public assistance.

The security of a guaranteed pension can help offset the much-lower salaries government employees receive compared to the private sector. Even with better benefits, overall compensation is lower in the public sector in Kentucky. A 2012 study by Rutgers professor Jeffrey Keefe for the Kentucky Center for Economic Policy shows that after adjusting for education, experience and demographic factors, public employees in Kentucky receive 12.8 percent less in total compensation (counting salary and benefits including pensions) than comparable employees in the private sector and 9.2 percent less on an hourly basis.

As mentioned previously, employee turnover would likely increase under a cash balance plan. Because defined contribution and hybrid systems like cash balance plans provide lower and less secure benefits for long-term workers, they make it harder to retain experienced employees. The private sector has tools to encourage retention of skilled employees not available in the public sector, like stock options. The only comparable tool in the public sector is the guarantee of a traditional defined benefit pension.

By reducing retention and harming the state’s ability to attract skilled employees, a switch to a hybrid cash balance plan could reduce the productivity and quality of public services. The makeup of the public sector workforce would change. It would include more employees who are less committed to their jobs...
and less likely to invest in skills that aren’t transferable to the private sector. More people may be reluctant to enter public employment because many of the skills utilized are not transferable to jobs in the private sector—for example, many public safety jobs have skills applicable only to that occupation. Overall, the workforce is likely to have less experience and expertise and lack the institutional memory that long-term employees provide.

Traditional defined benefit plans also encourage “efficient retirement”—meaning that they provide enough of a retirement benefit to allow employees to retire before their productivity begins to decline.9 But lower benefits would make it more likely that older employees delay their retirement date.

It has been argued that cash balance or defined contribution plans are a better fit for today’s more mobile workforce, providing greater incentive for highly-skilled employees to spend some time in the public sector and making it more likely that less-effective employees will leave because retirement benefits are portable. But these plans also incentivize the exact opposite result. The security and adequacy of traditional defined benefit plans make them a key tool in attracting high-skilled employees in the first place and encouraging them to stay in their jobs. And the better benefits provided by traditional plans make it more likely that less-effective employees will retire earlier rather than remaining on the job simply because of the need to earn more benefits.

**Cash balance plan would reduce retirement security for workers, impacting those families and the broader Kentucky economy.**

While benefits may increase for some employees who stay in the public sector a short period of time under a cash balance plan, benefits would be lower for long-term employees. Also, since under a cash balance plan employees have individual accounts, the plan in effect has no cost of living adjustment (COLA). The existing plan assumes an annual increase of 1.5 percent that can be suspended by the legislature (Senate Bill 2 also proposes eliminating COLAs for all retirees).

Benefits could also be lowered because a cash balance plan creates incentives for the retirement system to pursue a more conservative investment strategy. As mentioned, while the public sector would have to make up all of the difference if investment returns are less than four percent under the proposed cash balance plan, 75 percent of investment returns above that level would go to employee benefits. If the retirement system prioritized lowering the state’s risk, it could pursue a more conservative investment strategy that would result in substantially lower returns than the existing system and would translate into lower benefits for workers. Proposed changes to the retirement system board in Senate Bill 2 make that shift more likely.10 The historic rate of return since inception under the current system is an impressive 9.47 percent, more than enough to meet pension obligations if required contributions are made in full and benefit changes and COLAs are pre-funded.11

Higher turnover of employees who can withdraw their accounts in a lump sum under a cash balance plan could also impact investment returns. More turnover and withdrawal of lump sums will decrease the size of the investment pool and shorten the investment horizon, requiring greater liquidity in investments. That will exacerbate a problem Kentucky’s system already faces in which the low funding level reduces economies of scale and the ability to engage in a diversified investment strategy that includes alternative investments with higher expected rates of return.

Individual workers will take on more risk and have greater uncertainty about ultimate retirement benefits under a cash balance plan, which are also harder for workers to understand and plan around. Benefits would vary based on whether workers retire when financial markets are strong or weak, though this would be somewhat mitigated by the rate-of-return guarantee. An additional danger to retirement security is the option of a lump sum cash-out of account balances when employees leave under the cash balance plan.
The tendency of workers to withdraw monies from 401k and other accounts is playing a big role in reducing the resources Americans have for retirement.\textsuperscript{12}

Under the existing plan, Kentucky’s benefits are very modest compared to other states—especially after cuts were made in 2008. According to a national report on state pension plans, Kentucky’s formula multiplier for employees hired after that point—the number multiplied by years of service that plays a major role in determining ultimate benefit levels—of 1.1 to 1.75 percent for most non-hazardous employees is below the national average of approximately 1.95 percent.\textsuperscript{13} The final average salary calculation uses five years, while most plans use three. Even under the pre-2008 plan, the average state non-hazardous retiree receives only $20,508 a year, while the average county non-hazardous retiree receives $10,968 a year.\textsuperscript{14}

Traditional defined benefit plans are especially important to reducing hardships for groups of workers less likely to have other forms of wealth to rely on in retirement, such as many minorities and low-wage workers.\textsuperscript{15} At least some public sector workers in Kentucky are not covered by Social Security and thus would lack any guaranteed retirement option if the existing plan were eliminated.\textsuperscript{16} And as mentioned, less secure retirements also mean more retirees will struggle to make ends meet and will need greater assistance from public programs.\textsuperscript{17}

The increased economic security of traditional defined benefit plans is why employees prefer them.\textsuperscript{18} National opinion polls show that public employees consistently and strongly prefer defined benefit pensions.\textsuperscript{19} Of those states that offer employees a choice between types of plans, public employees overwhelmingly choose defined benefit plans.\textsuperscript{20} And contrary to some claims, young employees prefer defined benefit plans at least as much as other employees, if not more so.\textsuperscript{21}

Less retirement security and lower benefits would also impact the Kentucky economy. The Kentucky Retirement System is an important but unrecognized contributor to the state and local economies, providing $1.6 billion in benefits annually to 93,422 retirees, 95 percent of whom live in Kentucky.\textsuperscript{22}

\textit{The Kentucky Center for Economic Policy is a non-profit, non-partisan initiative that conducts research, analysis and education on important policy issues facing the Commonwealth. Launched in 2011, the Center is a project of the Mountain Association for Community Economic Development (MACED). For more information, please visit KCEP's website at www.kypolicy.org.}
Senate Bill 2 actually makes the long-term costs of the liability higher by pushing forward the length of time the state will take to pay back the liability. Senate Bill 2 includes changes to the board of the Kentucky Retirement System that could result in a more conservative investment strategy. Currently, five members of the board are elected by the system’s members, three are appointed by the governor and one position is held by the Secretary of the state Personnel Cabinet. Thus, employees constitute a majority of the board. Senate Bill 2 puts workers in the minority by increasing the number of gubernatorial appointees from 3 to 5.

Some local government employees in Kentucky are not covered by Social Security. Also Kentucky teachers, who are not affected by Senate Bill 2, do not have Social Security coverage.

Cash balance and defined contribution plans also limit public sector job opportunities when they are most needed—when the economy is bad and the unemployment rate is high. That's exactly when account balances tend to be lower because of stock market declines, creating job lock for current employees rather than opening up new opportunities.


