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INTRODUCTION

Challenges facing public retirement plans

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State and local retirement plans around the world are confronted with rising annual expenditures and increases in their unfunded liabilities. In response to these financial challenges, government policymakers have been making fundamental changes in their pension plans. In the USA, traditional defined benefit plans continue to cover most public employees, yet some states have adopted hybrid plans, others have shifted to defined contribution or cash balance plans, and still others are now giving employees' choices over their retirement plan. And the US state and local governments that have retained their traditional plans continue to enact policy changes that reduce plan generosity. Examples of such modifications include reducing the benefit generosity parameter, increasing the number of years used to calculate the final average salary, raising the ages and increasing the years of service needed for early and normal retirement, and boosting employee contributions to help finance pension benefits. For years, economists have examined how retirement plans influence the behavior of workers in the private sector, but only recently has attention been shifted to an examination of how state and local plan reforms affect public employees.[1]

This special issue of the *Journal of Pension Economics and Finance* includes four articles that examine various aspects of state and local retirement plans and how they affect state and local government budgets, employee behavior, and economic well-being in retirement.[2] Jeffrey Brown and George Pennacchi reexamine the important issue of how the liabilities of public retirement plans should be measured and reported. Selecting an appropriate discount rate is central to understanding the true magnitude of the unfunded liabilities of the pension plans of cities, counties, and states. Robert Clark, Emma Hanson, and Olivia S. Mitchell study the impact of

[1] A series of conferences organized by the National Bureau of Economic Research with support from the Smith Richardson Foundation has significantly increased the research on public retirement plans. Papers from previous conferences have appeared in special issues of the *Journal of Pension Economics and Finance* (April 2011), the *Journal of Public Economics* (August 2014), and the *Journal of Health Economics* (December 2014).

[2] These papers were first presented at an NBER conference in April 2015 which was supported in part by funds from the Smith Richardson Foundation.

pension reforms in Utah by estimating the choice of pension plans by newly hired public employees. A unique aspect of this study is its focus on how employees responded to a less generous retirement plan.

Historically, cost of living adjustments (COLAs) in monthly retirement benefits have been an important and costly component of public pension plans. Alicia Munnell, Jean-Pierre Aubry, and Mark Cafarelli present evidence on the prevalence of COLAs and how policy makers are reconsidering COLAs. Robert Clark, Emma Hanson, Melinda Morrill and Aditi Pathak describe the current landscape of supplemental retirement saving plans for public school teachers. In contrast to employer-provided saving plans in the private sector, school districts often offer their employees the option of participating in two or three different plans and these plans may have multiple vendors. This paper is one of the first studies to focus on employer-provided retirement saving plans in the public sector. In this introduction to the special issue, we provide a brief overview of the key concepts examined in these papers.

Discounting liabilities of public retirement plans

How to properly value pension liabilities is a prominent and controversial policy issue, as attested to a recent Government Accountability Office study of this.[3] The report found that 'experts sharply disagree on which approach should be taken to calculate these plans' estimated obligations for benefits promised to workers and retirees.'

Brown and Pennacchi posit that the appropriate discount rate for pension liabilities is a function of the objective or the potential use of funding measure thus generated. If the principal objective of financial reporting is to provide a measure of pension underfunding, they argue that the funding status should use a default-free discount rate. Alternatively, if the objective is to provide an accurate measure of the market value of pension benefits, then the analysis should use a discount rate that incorporates default risk into the calculation. The authors also discuss the choice of a default-free discount rate that should be used in the analysis. The magnitude of unfunded liabilities is substantially different depending on the discount rate employed in the calculation. Thus, the choice of the discount rate has significant policy implications.

Pension reforms in Utah

Clark, Hanson, and Mitchell explore how newly hired public employees in Utah responded to a pension reform that eliminated the state's traditional defined benefit pension. The new retirement system offered new hires a choice between a defined contribution plan and a hybrid plan both of which that are less generous than the pre-reform plan. The hybrid plan had a defined benefit component and a small defined contribution part. The authors found that approximately 60% of new hires failed to make any active choice and were automatically defaulted into the hybrid plan.

[3] Government Accountability Office, 'Pension Plan Valuation: Views on Using Multiple Measures to Offer a More Complete Financial Picture,' September 2014, GAO Report No. 14-264.

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Slightly more than half of those who made an active choice elected the hybrid plan. Their results on plan choice are consistent with earlier studies of how public employees responded when given the option of selecting their retirement plan.

Furthermore, individuals hired following the reform who failed to actively elect a primary retirement plan were less likely to enroll in a supplemental retirement account compared with new hires who actively selected a plan. Thus, it seems that many individuals who were unable or unwilling to make a choice on their primary retirement plan also failed to make an active choice to enroll in the retirement saving plans. Employees hired following the reform were more likely to leave public employment within 2 years of hiring, resulting in higher separation rates. The higher turnover rate for new hires reflects a reduction in the desirability of public employment under the new pension design; however, an improving economic climate in Utah gave workers increased employment options and likely accounts for some of the increase in the separation rate. An important implication of this research is that public pension reformers would do well to consider employee responses to pension reforms in addition to potential cost savings, when developing and enacting major pension plan changes.

The future of COLAs in public pension plans

Until the last decade, state and local retirement benefits were believed to be unbreakable promises to public employees from their government employer. Thus public employees were thought to have a higher degree of pension protection than private sector employees. For instance, in the USA the ERISA pension law provides legal protection for already-earned benefits through past work in private plans, private sector employers retain the right to reduce the generosity of pensions going forward and can even freeze or terminate the plans. By contrast, state constitutions and case law prohibit public employers from modifying retirement plan provisions after an individual is hired. This prohibition means that employees have the right to earn benefits under plan provisions in place when they were first hired, for as long as they remain on the job. Accordingly, if a public sector employer wishes to reduce future benefit accruals, such a change would usually apply only to new hires.

Historically, most public pension plans have provided regular, if not, automatic COLAs to their retirees. In response to recent financial pressures, however, many public plans have attempted to reduced or eliminate COLAs. Interestingly, some courts have concluded that COLAs are not a core benefit protected under the laws of the state and thus are changeable for current workers and retirees. Munnell, Aubry, and Cafarelli document the use of COLAs by public plans and how they evolved over the past few decades.

Retirement saving options of public school personnel

Unlike private sector employers, public school districts in the USA generally offer more than one type of supplemental retirement savings plan to their employees. Employer-provided saving schemes that school districts can offer include 401(k),

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403(b), and 457 plans. Moreover, while private sector employers typically select a single vendor for their 401(k) plans, school district administrators often allow multiple vendors to offer products in their 403(b) and 457 plans. Using payroll data on teachers and other personnel from public school districts in North Carolina, this study examines and seeks to explain individual variation in the probability of participation.

Clark, Hanson, Morrill, and Pathak find a wide variation in participation rates across the school districts in North Carolina, even though school personnel in all of the districts were covered by the same defined benefit pension plan, health plan, and retiree health coverage. They were also covered by a single state-wide salary schedule. Large differences in participation rates remain even after controlling for individual and district characteristics. The authors provide several reasons for these differences, including differences in marketing techniques by vendors, unobserved differences in management of the plans across districts, and unobserved differences in worker preferences.

Lessons learned

The articles in this special issue contain significant new research findings on the challenges currently facing state and local retirement plans. Brown and Pennacchi address the important issue of how to evaluate pension liabilities, and hence, to calculate funding ratios. They argue that the appropriate discount rate depends on the intended use of the funding measures. The debate on this issue typically has failed to focus on this distinction and to recognize that both measures may be valuable. It will be interesting to see if their findings help to reconcile differing opinions on this important issue. An interesting policy question is whether it would be good public policy to report funding status using both methods.

Many state and local governments are considering major changes in their pension plans in an effort to reduce the cost of retirement plans. Clark, Hanson, and Mitchell present a detailed analysis of pension reforms in Utah which shift the state plan from a traditional defined benefit plan to a choice between a hybrid plan and a defined contribution plan. The objective by the state was to reduce the public cost of retirement plans. The authors show that selecting a default plan is a key decision in any such reform and they also conclude that administrators should consider the behavioral responses of employees to plan changes. A key question is whether future reform proposals will explicitly consider the impact of plan changes on turnover and retirement saving patterns of public employees. Further research is needed to determine how employees respond to pension reforms that reduce the generosity of their retirement benefits.

Cost of living increases in benefits to retirees are very common in the public sector. Regular increases in retirement benefits help retirees to maintain their standard of living throughout retirement. However, the open-ended promise to continuously raise retirement benefits is a costly component of retirement plans. Recently, these provisions have received considerable scrutiny as state and local governments have attempted to reduce or eliminate these provisions from their retirement plans. Munnell, Aubry, and Cafarelli provide an assessment of the status of COLAs and

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the legal battles over changes in them. Further economic and legal research is needed as more public pension plans reconsider these promises.

Retirement policies in the public sector are much different from those in the private sector of the economy. Most full-time public employees continue to be covered by defined benefit plans and in addition, most are given the opportunity to participate in voluntary retirement saving plans. Public sector employees often have the option of contributing to several different plans. Clark, Hanson, Morrill, and Pathak provide one of the first studies examining retirement saving plans in the public sector. Their paper, which focuses on school teachers in North Carolina, illustrates several issues facing employers and employees. Why do employers offer more than one type of plan and often select multiple vendors? How do employees select among these plans? Additional research is needed on both of these questions if we are to understand the role that retirement saving plans play for public employees.

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