HALTING A RUNAWAY TRAIN: REFORMING TEACHER PENSIONS FOR THE 21ST CENTURY

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Can public-sector pensions be reformed, particularly for teachers? Everyone knows that unfunded and underfunded pension systems of the traditional kind ("defined benefit"), plus ancillary health care costs and related benefits for retirees, are burdening state and local education budgets across the land, particularly at a time of broader economic frailty. But few communities and states have yet demonstrated the wisdom, fortitude, capacity, and imagination to devise workable alternatives and put them into place. We're at a point in time where a major public-policy (and public-finance) problem has been defined and measured, debated and deliberated, but not yet solved.

Except where it has been. There aren't many such places, especially within public education, but it's important to learn all we can from them and to try to distill lessons that others may apply.

That's what the essays in this volume seek to do: illuminate both the upside and downside of pension reform as it has been undertaken by various organizations, companies, and governmental units, with an eye to extracting insights and strategies for the public-education sector.

BACKGROUND

In recent years, school reformers in the United States have paid much deserved attention to the quality of teachers and teaching. The education field has traditionally clung to the belief that the best teachers are those who stick with this work for their entire careers—ten, twenty, thirty years, usually in the same school or school system, certainly in the same state. To recruit and retain such teachers, school districts and states have long depended on the ability to promise them generous benefits—including pension and health care plans—when they retire. To some extent, this promise has substituted for more generous salaries while they're on the job. Over the last decade, however, more evidence has surfaced showing that the best teachers may be young, middle aged, or old—and in any case, it's clear that fewer of today's teachers plan to remain in the classroom (or in the state) for their entire careers.[1] Suddenly, the traditional defined-benefit (DB) pension system—which builds retirement capital slowly at the outset of a worker's career, and often cannot be merged with other retirement plans after a job or geographic switch—appears ill-suited to the work, lifestyles, and needs of a younger and more transient teacher population. Besides which, the DB pension system is almost always very expensive, both for taxpayers and (depending on the structure of the plan) for its future beneficiaries.

Despite these demographic and workforce changes—and mounting dollar costs and unfunded liabilities—traditional DB plans remain a staple in the education arena, as in the public sector generally. These plans, which stipulate monthly payments for retirees—for as long as they live, usually based on their highest average salary and number of years employed—have become increasingly unmanageable. Their payouts are often more generous than those provided by private-sector retirement plans, but they come at a high cost.[2] Employers must contribute more and more as investment returns diminish and the number of beneficiaries rises, in some cases leaving them paying upwards of 20 percent of employee payrolls into the system just to meet current retirement payouts.

What is the alternative? The best known and most obvious is the "defined-contribution" (DC) retirement plan. This plan is better attuned to the needs of younger, more transient teachers *and* the wallets of employers. DC plans stipulate the amount of funds put *into* a plan—not the amount that is eventually paid out. They are typically funded with a blend of employee and employer contributions—plus whatever gains (or losses) the plan encounters in the investment market. Because contributions to such plans are set at the outset, neither employers nor workers are on the hook for meeting a set payout down the road. And as DC plans often allow employees to take their contributions with them when they switch jobs or geographies, they have the potential to address more adequately the needs of a modern work force while saving taxpayers money over the long term.

But is it possible to get there from here? To transition from an outmoded, rigid, and expensive public-sector pension system to a more modern and flexible one that better meets the needs of today's education workforce and the pocketbooks of today's taxpayers? This report set out to shed light on that issue. We scoured the land for examples of both public and private entities that have transitioned, either completely or partially, from DB to DC programs.[3] They include examples from the federal government, state and county governments, the private sector, a university system, and a quartet of charter schools. Specifically, we sought to address three key questions:

1. In the process of modernizing, modifying, even replacing the retirement system of a complex organization, what challenges arise and how have they been addressed?
2. What does the process of transition look like when it works well—and when it doesn't?
3. How can one retirement plan—or a combination of plans—best meet the needs of employees with different priorities and career trajectories? How, for example, should employers balance the desire for portable plans against the retention of valued employees?

THE CASE STUDIES IN BRIEF

We investigated six cases of pension reform. Below is a thumbnail sketch of each.

Politics and Economics Force Feds to Change. By the 1980s, the cost of federal retirement benefits threatened to become unsustainable without major increases in contributions from employees and taxpayers. Burgeoning government deficits reached $200 billion by the middle of the decade and, with a retirement age as young as fifty-five, retirees were often living years longer than they had worked—and living far longer than their predecessors. It was an expensive problem that was only growing worse.

Fiscal woes—and some legislative nudging—eventually overrode political differences enough to allow for compromise: Uncle Sam limited enrollment in the traditional DB program (the "Civil Service Retirement System") to existing federal employees. For new government workers, lawmakers introduced a blend of reduced DB benefits and a DC-style "Thrift Savings Plan." The result (the "Federal Employees Retirement System") was a cheaper but still generous retirement plan that is also portable.

Making Change in Utah and Alaska. Unfunded liabilities for state pension plans have ballooned in many states in the last decade, both because of historically poor management of plans and low investment returns during the economic downturn. While most states have only tinkered with their pension provisions to address these liabilities, Utah and Alaska are two states which have acted decisively to create new plans under which employees shoulder more expense and risk. Utah closed its existing DB plan to new workers and created a choice (a DC plan or a hybrid DB/DC plan) for employees hired after July 1, 2011. Alaska closed its DB plan to new employees in 2005 and created a mandatory, 401(k)-style DC plan for all new state hires, including school teachers.

Faced with vehement employee and union resistance, both states overcame opposition by guaranteeing benefits for existing employees while instituting new arrangements for new workers. But both now face the burden of sustaining their lingering DB plans without new workers paying into them. With this consideration in mind, the success of both programs is yet to be determined.

Oakland County, MI: Poster Child for DC Plans. Oakland County tackled its financial stability long before the economic downturn in 2008. In the early 1990s, reeling from the decline of the U.S. auto industry, it moved proactively to institute a DC plan—even though its DB plan was still relatively healthy.

The county and its unions engaged in a straightforward negotiation process that forestalled acrimony and rendered the final proposal palatable to all sides. The county set its priorities based on its expected income and presented its unions with a realistic proposal, insisting that any changes be based on sound fiscal policy. The reform passed with little opposition—doubtless due, at least in part, to a Michigan law that prohibits strikes by public workers and allows a public employer to impose its last, best offer in the event of an impasse.

When Big Blue Unplugged Its Big Pension Plan. In 1999, the International Business Machines Corporation (IBM) redesigned its pension system to make itself more competitive in the modern economy, particularly when facing nimble, information-technology start ups. The company was also downsizing its workforce and sought to create a new retirement system that would better meet the needs of a younger, changing cadre of employees while encouraging some workers to stay and others to leave—all while reducing expenses. IBM sorely misjudged employee sentiment, however, and set off a period of raucous union activity, congressional inquiries and legislation, and a lawsuit in which the Supreme Court eventually ruled in the company's favor.

But IBM was not finished. Just a few short years after its first switch, IBM announced a new switch to a DC plan. This time, however, it brought workers into the process early and redirected some of the savings into hiring investment counselors for them. The company encountered less resistance the second time around—and today offers what is often regarded as one of the best DC plans in the private sector.

Reform Falters at the University of Missouri. To curb mounting (and unpredictable) pension costs, the University of Missouri took preemptive steps to shift risk away from the employer and to reduce and stabilize its institutional contributions. It first instituted modest employee contributions to its traditional DB plan, then introduced a radical proposal to replace that plan with a DC plan for all new workers. Faced with concerns over the impact of such a change on low-income employees, however, the reform stalled, and Missouri enacted a more palatable hybrid DB/DC plan.

The university's experience shows the importance of having strong, committed leadership to push for a new plan. It also demonstrates that, while fiscal solvency is an employer's main concern in most any pension reform, concerns surrounding employees must not be ignored. While a DC plan might be the optimal financial choice from the employer's standpoint, other options may prove more viable in an atmosphere of fear and anxiety.

Four Charter Organizations Walk the Pension Tightrope. All charter schools must balance their priorities, such as keeping costs in line while attracting and retaining excellent teachers. As the four examples in this case show, the actual handling of that balance differs enormously from school to school.

- **Lighthouse Academies:** When Lighthouse opened its first schools in Indiana, the state did not allow charters to opt out of the state pension system. Knowing it could save money and attract younger teachers with its own retirement plan, Lighthouse worked through the legislature to change that law. In time, it brought its Indiana employees into its DC plan and used the savings to fund bonuses and incentives for them.

- **Mid-Michigan Leadership Academy:** Mid-Michigan struggled from financial (and institutional) instability; in order to bring costs under control, it exited the state pension system in 2005 and contracted with a personnel services firm to provide employees and a DC retirement plan. While the school's budget remains pinched, it has used savings to raise salaries and hire an additional teacher.

- **Bay Haven Charter Academy:** When Bay Haven, a high-achieving charter group in Florida, began losing employees in 2008, it found that many staff members were dissatisfied with its DC plan and wanted to join the state system. So Bay Haven made an unusual choice: It opted *into* the state retirement system. While it now faces higher costs, Bay Haven weighed its talent needs against its budget and found the additional costs worth the expense.

- **Lafayette Academy:** A New Orleans charter school that opened after Hurricane Katrina, Lafayette employed many teachers who had previously worked for the district. At their urging, Lafayette joined the Louisiana state pension system in 2009. Soon, however, costs soared and the school pulled out again in favor of a DC plan. Lafayette thereby did what it needed to do in order to stay in operation; the effects of that choice on its talent pool and academic performance are a gamble that the school had to take.

What do we take away from these cases? Three lessons.

First, this is messy, complicated work, fraught with challenges. **Yet smart organizations *can* prepare for them.**
The organizations that enacted the most dramatic and efficient pension reforms were those that moved proactively, prepared their employees for the shift, and mustered hard data to document their assertion that the status quo had become unsustainable and change was therefore unavoidable.
In almost every case we examined, the greatest challenge in enacting pension reform was to convince current employees that change was necessary and that it would not be detrimental for them. Those organizations that managed the smoothest

transitions gauged employee sentiment at the outset and informed employees of new developments and potential outcomes well before any change took place. They also effectively demonstrated to their employees that inaction would lead to even more dire consequences—at best, layoffs and other budget cuts, and at worst, the dissolution of the organization.

Second, cost savings from pension reform may be real but not immediate. One of the strongest criticisms that opponents can hurl at pension reformers is that changing plans may actually cost more in the near term. That's because, without new employees to subsidize lingering DB plans, the employer is suddenly on the hook for more costs going to support today's DB retirees and any current employees who remain in the DB plan. One way to ease those costs is to shut down the DB plan entirely and include existing as well as new employees in the new plan. But as several cases in this volume show, the stormy political climate surrounding reform—even in private institutions—does not often tolerate such sweeping moves (and placing all employees, especially those near retirement, into a new DC plan may not be fair). In any pension switch, the ability to show how pension reform can save thousands, millions, or even billions of dollars *down the road* is pivotal. This is true not only before the reform takes place but in the years after; in many of the cases we examined, opponents to the reforms remain vocal to this day, well after the new plans have gone into effect.

Third, employers need not choose between saving money and disregarding employee concerns. Though most organizations examined in this volume adopted new retirement plans in order to save money, many took pains to minimize real or perceived harm to their employees. That doesn't mean avoiding all pain—a key goal of pension reform is to shift some investment risk and expense from employer to employee, and most every transition documented within these pages did so—but employers can take actions to keep that discomfort within reasonable bounds. Some organizations reinvested savings elsewhere—e.g., one charter school raised teacher salaries and bonuses, while another employer used savings to hire investment counselors for its employees. Others found ways to overlay different plan components into a blended retirement system so that employees would benefit from a menu of options and be somewhat protected from investment risk. Utah, for instance, instituted an innovative hybrid plan that offers employees DB-style protection while capping state contributions. At the end of the day, saving money in and of itself is not the ultimate aim of any reform; rather, saving money is a means to stabilizing an organization and making it stronger, healthier, and more productive—all of which is good for the organization's present and future employees, too.

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[1] Institute of Education Sciences, *Teacher Attrition and Mobility: Results from the 2008-09 Teacher Follow-up Survey* (Washington, D.C.: U.S. Department of Education, 2010), 6, http://nces.ed.gov/pubs2010/2010353.pdf.

[2] While DC plans outperformed DB plans in the bull market of the late 1990s, DB plans, because they are professionally managed, generally outperform DC plans over time, as they did in the early 1990s and 2000s—even during the bull market of 2003 to 2006. Towers Watson, "Defined Benefit vs. 401(k) Plans: Investment Returns for 2003-2006," Watson Wyatt Insider, June 2008, http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=19148.

[3] We also examine one charter school that converted from a private-sector DC plan to a state public-pension plan.

Introduction

Can public-sector pensions be reformed, particularly for teachers? Everyone knows that unfunded and underfunded pension systems of the traditional kind ("defined benefit"), plus ancillary health care costs and related benefits for retirees, are burdening state and local education budgets across the land, particularly at a time of broader economic frailty. But few communities and states have yet demonstrated the wisdom, fortitude, capacity, and imagination to devise workable alternatives and put them into place. We're at a point in time where a major public-policy (and public-finance) problem has been defined and measured, debated and deliberated, but not yet solved.

Except where it has been. There aren't many such places, especially in public education, but it's important to learn all we can from them and to try to distill lessons that others may apply.

That's what the essays in this volume seek to do: illuminate both the upside and downside of pension reform as it has been undertaken by various organizations, companies, and governmental units, with an eye to extracting insights and strategies for the public-education sector.

Discussions surrounding the costs and possible alteration of pension systems have taken on greater urgency in today's bleak fiscal climate. To address ballooning pension liabilities, some states have enacted reforms that have begun to deflate generous but unwieldy benefits. Wisconsin is perhaps the most visible example of such change. Despite droves of incensed public employees camping out at the statehouse in protest, the state passed legislation in the spring of 2011 that, besides narrowing the scope of collective bargaining, required employees to contribute more to their own pension plans. But Wisconsin is not alone: Sixteen states increased employee pension contributions in the last year, and another fifteen raised age and service requirements for normal retirement.[1] Indiana went so far as to create a new defined-contribution (DC) plan into which employees can opt (although those who take no action will be placed into the traditional DB plan.)

WE'RE AT A POINT IN TIME WHERE A MAJOR PUBLIC-POLICY (AND PUBLIC-FINANCE) PROBLEM HAS BEEN DEFINED AND MEASURED, DEBATED AND DELIBERATED, BUT NOT YET SOLVED.

For a district or state looking both to attract fresh talent and to reduce its pension costs, DC plans are the clear choice. But how can a public system transform its DB pension into a DC retirement plan? That's where this report comes in. We set out to find both public and private entities that have transitioned from DB to DC programs. Specifically, we sought to address three key questions:

1. In the process of modernizing, modifying, even replacing the retirement system of a complex organization, what challenges arise and how have they been addressed?
2. What does the process of transition look like when it works well—and when it doesn't?
3. How can one retirement plan—or a combination of plans—best meet the needs of employees with different priorities and career trajectories? How, for example, should employers balance the desire for portable plans against the retention of valued employees?

CONTEXT

After World War II and the end of the Great Depression, young workers entered the American workforce in droves. That influx meant a flood of contributions into DB pension plans. Combined with a robust economy and high investment returns, inputs outpaced pension benefit payments. DB plans accumulated great wealth and, blessed with excess, their directors often increased benefits and sometimes reduced employee and employer contributions. Such shortsighted moves did not, however, anticipate downturns in the stock market or account for changing workforce demographics: Employees began living longer and collecting retirement benefits for years longer than their predecessors, leaving fewer workers supporting each retired colleague.

In a few short decades, many DB plan benefits began to outpace their revenue inputs, and employers started rethinking their traditional pension offerings. Indeed, it was the fear of financial obligations, combined with a Reagan-era push in Congress to make the federal government more businesslike, that resulted in the federal government's 1986 transition from a pure DB plan to a hybrid DB/DC system (see Chapter I). The federal government followed in the footsteps of many small and medium-sized companies that had altered their pension plans after changes in federal law made DC plans more attractive. The shift has been dramatic. In the 1980s, 80 percent of American private-sector workers in medium and large firms were covered by DB plans, compared with fewer than 30 percent today.[2]

But state and local governments have been slow to follow suit. Today, about 80 percent of their workers remain enrolled in DB plans—and many of those workers include the teachers, administrators, and support staff who operate our public schools.[3] In fact, Alaska is the only state that has created (and so far maintained) a mandatory DC plan for all new teachers as part of an overall mandatory plan for public workers statewide.[4]

The economic downturn that began in 2008 has, however, forced more public employers to address the mounting liabilities of their DB plans. In Ohio, for instance, the State Teachers Retirement System lost 31 percent of its value from 2007 to 2009.[5] Nationally, the Pew Center on the States estimates that the gap between benefits promised and money set aside to cover them reached $1.26 trillion in 2009, a 26 percent increase in just one year.[6] The recession has served as a wake-up call to obstinate states and localities—and a few have courageously stepped forward, refusing to kick the can down the road any longer.

In this report, we look at some of these transitions but let's turn first to how DB and DC plans actually work.

DB AND DC PLANS IN A NUTSHELL

Defined-benefit systems are pension plans that stipulate a monthly payment for retired employees. In private industry, they are mostly funded by employers, while in the public sector they are often funded by both employers and employees. The monthly retirement payments can be calculated in different ways: In some cases, the benefit is a predetermined monthly lump sum multiplied by the number of years a worker was employed. For example, a DB plan offering $100 for each year of work would pay $3,500 a month if the employee worked for thirty-five years (35 x $100). The most common benefit formula, however, is based on a percentage of employees' final average pay, usually what they earned during their last three to five years. For example, an employer might choose to pay out 1.5 percent of salary per year of service times the average of an employee's last three years of wages. In this case, a teacher averaging $50,000 a year for the last three years of work would receive a retirement benefit of $22,500 a year after thirty years of service ($50,000 x 1.5% x 30). The employer is responsible for honoring that commitment until the retiree's death. Contributions to these plans are calculated based on an assumed investment return—often around 8 percent. When investment markets plummet, however, as in the recent economic downturn, so does the value of the pension fund, and employers are left with large liabilities to pay in order to meet their promised retirement payouts.[7]

Beyond the risk placed on employers, a key criticism of DB plans is that they are not portable. Often, employees do not vest in their pension plans for a decade or more—in other words, if a worker switches jobs before working for a certain number of years, he can forfeit some or all of the employer contributions made into his plan. Many DB plans *depend* on a certain number of workers entering the system and leaving for another job before becoming vested in the plan (see the University of Missouri's experience in Chapter V). In effect, these workers subsidize the plan.

Instead of promising a specific benefit upon retirement, a defined-contribution plan, such as a common 401(k) plan, is based on the amount contributed by the employee and (usually but not always) by the employer—plus whatever increase/decrease in value the account experiences in the market. In general, DC plans are popular with employers because: (1) expenses are more predictable, as contribution obligations are independent of investment returns; (2) contributions can be lower than those for DB plans, especially where DB contributions have spiraled out of control; and (3) the employee assumes all downstream risk for the success or failure of future retirement earnings.

Whether DC plans are better than DB plans for employees depends on the employee. For young teachers—or more mobile educators—a DC plan's portability is a huge plus. In fact, DC plans are especially common at private colleges and universities interested in attracting budding—but often transitory—faculty members. On the other hand, because workers decide how their funds are invested, many employees fear making poor choices or not tracking their investments closely enough to avoid losses.[8]

While DB and DC plans can seem straightforward on paper, transitioning from one to the other is a messy, complex, and unpredictable process. The organizations that we examine in this volume each followed a different, often winding path toward reform. Some implemented reform only when their DB plans were nearly decimated. Others moved proactively to address liabilities before they grew. But the lessons that can be drawn from each show that reform can be implemented in a smart, resourceful manner that fits the needs of both employers and employees.

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[1] Ronald K. Snell, *Pensions and Retirement Plan Enactments in State Legislatures* (Washington, D.C.: National Conference of State Legislatures, 2011), 1, http://www.ncsl.org/documents/employ/PensionEnactmentsSept30-2011.pdf.

[2] *EBRI Databook on Employee Benefits* (Washington, D.C.: EBRI, 2005), Tables 10.1a and 10.1b, http://www.ebri.org/pdf/publications/books/databook/DB.Chapter%2010.pdf.

[3] Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in the United States, March 2010* (Washington, D.C.: U.S. Department of Labor, 2010), 350, http://www.bls.gov/ncs/ebs/benefits/2010/ebbl0046.pdf.

[4] West Virginia created and abandoned a mandatory DC plan for teachers not once but twice since the 1940s because it wasn't producing the needed returns for workers. Nebraska created a mandatory DC plan in the 1960s, but didn't include teachers—and in 2003, the state established a cash-balance plan in its place because the DC plan wasn't producing desired investment returns. Finally, Michigan created a mandatory DC plan in 1997, but it did not include teachers.

[5] "Comprehensive Annual Financial Report 2009," State Teachers Retirement System of Ohio, 14, https://www.strsoh.org/pdfs/CAFR2009/2009_CAFR.pdf.

[6] Pew Center on the States, *The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Costs* (Washington, D.C.: Pew Charitable Trusts, 2011), 1, http://www.pewcenteronthestates.org/uploadedFiles/Pew_pensions_retiree_benefits.pdf. Note that the National Conference on Public Employee Retirement Systems criticized the Pew report, saying it relied on dated information and that public-pension funds had enjoyed very favorable returns since the market collapse. See the National Conference on Public Employee Retirement Systems's news release on the subject, dated April 26, 2011, at http://www.ncpers.org/Files/2011_04_26_pew_report_flawed.pdf.

[7] During the crash, pension funds lost 20 to 30 percent or more of their value. This reached the extreme in Illinois, where the official unfunded public-pension liability hit $77.8 billion in 2010, an amount equal to more than $6,000 for each Illinois resident. (See "Shortfall Threatens Illinois Pension System," National Public Radio, March 24, 2010, http://www.npr.org/templates/story/story.php?storyId=125076655.) Private retirement plans were also hit hard. General Motors, for example, was brought to bankruptcy, in part, by significant, unfunded pension liabilities.

[8] That said, companies with DC plans often provide employees with investment advice and offer model portfolios (often called lifecycle plans) to match an employee's age and expected number of years before retirement.

I. Politics and Economics Force Feds to Change

Government pension systems—behemoth institutions largely shaped by the people they serve—are resistant to change. Traditionally, most public-pension systems at the federal, state, and local levels have functioned as defined-benefit (DB) plans. Though DB plans have grown increasingly unsustainable over the last half century, racking up significant unfunded liabilities, the vast majority of public-pension systems today continue to rely on them. Indeed, about 80 percent of state and local government workers participate in such plans at present.[1] Remarkably, however, a quarter century ago the biggest government of all broke the mold: The federal government significantly altered its pension system, retaining but modifying its DB plan while adding a defined-contribution (DC) option for employees.

By the 1980s, revamping the federal government's traditional DB plan—known as the Civil Service Retirement System (CSRS)—was all but imperative. The cost of benefits under CSRS threatened to reach unsustainable heights, absent significant additional contributions from both employees and taxpayers. With a retirement age as early as fifty-five, an aging population living years longer than the previous generation, and retirees often enjoying retirement for years longer than they worked, the federal pension obligation was an expensive and underfunded problem that was only growing worse.

Enter the Federal Employees Retirement System (FERS), which was created in 1986 and phased in for federal employees beginning in 1987. Advocates of FERS argued that it would align federal retirement plans more closely to those of the private sector by making it easier for employees to enter and leave government without penalty—an aspect of "portability" that is central to many modern plans. Just as important, FERS was championed as a way to save the government money. It was intended, eventually, to replace the CSRS as the pension plan for the U.S. government's civilian workforce. That hasn't quite happened, as a few federal workers still remain in CSRS today, and as a handful of smaller pension plans have emerged to cover particular agencies and types of personnel. But the change was still profound.

The overhaul of the federal retirement system provides essential lessons for anyone seeking pension reform today. While alternate pension models had existed in the private sector long before the 1980s, the federal pension makeover had to await an agreeable political atmosphere combined with a bleak financial outlook before reform was possible. Still, the overhaul faced significant resistance, both from employee unions and from individuals hesitant to exit the old model for the new. Though the new system offered potentially greater benefits for most federal workers, few took the initiative to switch to FERS.

POLITICS AND FINANCE FOSTER A PIONEERING SYSTEM

FERS grew out of an initiative to reduce burgeoning federal deficits by reconfiguring the government to function more like a private-sector organization. We would hardly blink at the figure today, but in the early 1980s the federal deficit was a then-staggering $200 billion and rising.[2] Policymakers floated various solutions to reduce spending, most famously the

Gramm-Rudman Act, which mandated unpalatable across-the-board cuts if Congress could not cut enough on its own.

The political and economic times were just as dismal as those in which we find ourselves today. The 1973 oil crisis, high unemployment along with tepid economic expansion in the 1970s, and a second energy crisis in 1979 all preceded a mild economic downturn in 1980. By July 1981, that downturn had deteriorated into a grave recession that lasted until November 1982. Moreover, the country was beset by rampant public dissatisfaction with government: Memories of the Vietnam War were still fresh, Richard Nixon had resigned in disgrace in 1974, and the nation had been humiliated by the 1979–81 Iranian hostage crisis. Beyond all this, Uncle Sam's inability to limit his spending to his income was troubling to many Americans. While reforming the pension system was no deficit cure-all, it did promise to save at least a few billion dollars a year up front and, more importantly, to reduce the government's unfunded liability to future retirees by tens of billions.

WHILE REFORMING THE PENSION SYSTEM WAS NO DEFICIT CURE-ALL, IT DID PROMISE TO SAVE AT LEAST A FEW BILLION DOLLARS A YEAR UP FRONT AND, MORE IMPORTANTLY, TO REDUCE THE GOVERNMENT'S UNFUNDED LIABILITY TO FUTURE RETIREES BY TENS OF BILLIONS.

Ronald Reagan entered the Oval Office in 1981 vowing to curb public spending and shrink government. In Reagan's view, a bloated federal workforce was part of the problem. One of his first acts as president was to freeze the hiring of federal workers. (More famous was his later firing of 11,000 air traffic controllers for illegally striking for higher wages and a shorter work week.) Though such drastic maneuvers contributed to a charged political atmosphere, few public officials could deny that something had to be done to better align federal spending and income; and many agreed that the unsustainable federal pension plan was a good starting point for reform.

A BRIEF HISTORY OF THE CIVIL SERVICE RETIREMENT SYSTEM

To understand how the Civil Service Retirement System had become so costly, it's helpful to understand its origins and development. Created in 1920, CSRS was, theoretically at least, designed to keep the federal government from becoming an old folks' home by providing passage out for workers too old or disabled to continue working.[3] The federal civil service itself had been created in 1872 in the aftermath of a string of patronage-related scandals. For the first time, federal workers were legally protected from arbitrary and political abuse, including being fired due to old age. But the civil service protections generated unintended side effects. For one, federal employees, many of whom were seventy or older by 1920, could retain their jobs (and paychecks) as long as they reported for work.[4] By the time the CSRS was created, some employees had been working for the federal government for thirty-seven years under the civil service.

CSRS was one of the first retirement systems in the nation. It would go on to serve as a precedent for Social Security, which was legislated for the general population in 1935, and for state retirement systems and further improvements in some public and union pension systems. For example, increases in CSRS benefits were linked by law to the Consumer Price Index

(CPI) starting in 1962, more than a decade before Congress ordered them for Social Security benefits.[5]

In the early years, employee and employer contributions were more than enough to pay benefits. This was common among budding public systems, including Social Security, when workers paying into the system outnumbered retirees. Flush with cash from 1942 to 1969, the CSRS spent it, with Congress voting to boost benefits and pile on cost-of-living adjustments that sometimes exceeded the CPI increase.[6]

Differences between the CSRS and Social Security, dating back to the 1930s, fueled initial public dissatisfaction with the federal retirement program. Social Security was never structured to serve as the sole source of income for a retiree; it was intended to be paired with a pension plan and personal savings. As CSRS was far superior to anything Social Security offered taxpayers—and as the introduction of Social Security coverage for workers covered by CSRS would oblige a reduction in CSRS benefits—federal workers successfully lobbied to remain out of the new Social Security system. State and local government employees with pension plans of their own followed suit. From the beginning, many perceived this dual, public-private system as unfair, and through the years, lawmakers worked to bring more and more public workers under the Social Security umbrella. By 1950, employees in some state and local governments were participating in Social Security (some still remain outside today) along with temporary and part-time federal employees not under a federal retirement system.[7] Later in the decade, military personnel were included in Social Security. This gradual inclusion of public employees in federal retirement systems extended into other areas as well: In 1982, federal workers were covered by Medicare hospital insurance. Numerous studies were conducted concerning the advantages and drawbacks of covering federal employees under Social Security. In 1979, the Advisory Council on Social Security stated that income-security goals could be achieved only if all workers were covered by Social Security.[8]

"By the 1970s Social Security covered nine out of ten workers, and non-universal coverage created gaps, overlaps, and windfalls in benefits for noncovered workers and their families," noted Richard G. Schreitmueller, an actuary working on the U.S. Senate staff in the 1980s. He had an insider's view of the shift away from CSRS. "[But] in practice, covering federal workers raised many problems of plan design, legislative jurisdiction, and acceptance by employee organizations, and so it had to await a time when the arguments favoring coverage became stronger and better accepted."[9]

FROM THE BEGINNING, MANY PERCEIVED THIS DUAL, PUBLIC-PRIVATE SYSTEM AS UNFAIR, AND THROUGH THE YEARS, LAWMAKERS WORKED TO BRING MORE AND MORE PUBLIC WORKERS UNDER THE SOCIAL SECURITY UMBRELLA.

By 1981, fiscal realities began to eclipse the issue of fairness. In addition to the federal government's perpetual budget deficits came new concerns about dwindling Social Security trust funds and fears that the funds would run out of money as benefit payments outstripped income. A national commission appointed by President Reagan to recommend ways to strengthen Social Security finances faced choices similar to those today: Congress could reduce benefits and/or increase taxes. Among other ideas, commissioners recommended covering *new* federal civilian employees under Social Security.[10] Both conservatives and liberals liked this idea. Conservatives applauded it because they considered it fairer to taxpayers. Liberals figured that government workers' contributions would help counter the Social Security system's long-term money woes.

A MORE MODERN PENSION PLAN FOR GOVERNMENT

In 1983, Congress finally rendered the creation of a new retirement system all but inevitable by mandating Social Security coverage for all new federal hires, including employees of the legislative and executive branches, members of Congress, federal judges, and executive-level appointees.[11] It now made no sense for federal employees to continue to receive full CSRS benefits or to pay full CSRS contributions. Like it or not, the government was moving toward a new or revamped retirement plan that would be paired with Social Security.

Ideas for change ranged from simply revamping the existing DB plan to replacing it with a DC plan that would mirror those used by private-sector businesses. The basic contours of a new plan started to take shape under the leadership of Senator Ted Stevens (R-AK). (By 1985, Republicans controlled the Senate and Democrats the House; the Reagan administration mostly took a hands-off attitude to retirement, leaving it up to Congress to solve the pension problem.) Federal employees would receive Social Security, and also a guaranteed (but much more modest) defined benefit for their public service. The retirement age would be raised and incentives put in place to delay retirement further still. (Previously employees could retire in their early fifties with full benefits.) And the government would also contribute to a DC-style "Thrift Savings Plan" on employees' behalf—which they could supplement with their own money.

Stevens and other proponents argued that CSRS retirement ages were too low and cost-of-living adjustments too generous; that the CSRS plan was hugely underfunded; that some retirees earned more than the workers who replaced them; and that costly "double-dipping"—the practice of an employee retiring and then returning to work for the same employer, thus drawing both a pension and a paycheck—was widespread. But while a consensus was building around what that plan might look like, some strong federal-employee union lobbies sought to maintain the status quo. Opponents of the reform countered that government pay and benefits were below levels for similar private-sector jobs and that wages were not keeping pace with inflation.[12] In addition, workers complained that they were not financial experts and were apprehensive about the idea of taking more personal responsibility for their retirements, despite the dramatic move in that direction among private-sector plans.

The chronic federal budget deficit cast a shadow over the debate and served as a stimulus to keep lawmakers focused on revamping CSRS. One budget-cutting driver—the Gramm-Rudman Act of 1985—mandated across-the-board cuts in most federal programs unless budget-reduction goals were met. Lawmakers generally dislike this method of trimming the budget, as it reduces or eliminates their own "vital" programs along with everyone else's "superfluous" ones, and in 1985 they sought alternatives to such draconian cuts. Saving money on federal-employee retirement programs seemed to many lawmakers to be an obvious solution.[13]

FERS, as eventually constructed in Stevens's proposal, was designed to reduce the deficit by $8.4 billion over five years and by tens of billions of dollars in the out-years.[14] Expenses were projected to remain constant at about 36 percent of pay until 2020. After that, they would gradually drop to about 23 percent. FERS would cut the federal government's unfunded liability immediately, from about $544 billion for CSRS alone to about $486 billion for both CSRS and FERS.[15]

Adoption, however, was not a straightforward process. Stevens withdrew an early reform bill in the face of objections from federal unions, which were hard at work lobbying lawmakers. Still, budget angst ensured that movement toward reform did not stall. Members of Congress and their staffs redoubled their efforts to learn about pensions and how they might build consensus for reform. Jamie Cowen, who served on Stevens's staff, recalls that a series of forums conducted by pension experts was vital in building expertise to tackle reform: "In retrospect, it was probably the most creative and successful thing we did throughout the entire pension reform process." The forums helped educate key staff on how to design a workable federal retirement system that included Social Security coverage.[16]

BUDGET ANGST ENSURED THAT MOVEMENT TOWARD REFORM DID NOT STALL. MEMBERS OF CONGRESS AND THEIR STAFFS REDOUBLED THEIR EFFORTS TO LEARN ABOUT PENSIONS AND HOW THEY MIGHT BUILD CONSENSUS FOR REFORM

In the fall of 1985, after two years of research and negotiations, a compromise proposal was worked out in the Senate under the leadership of Stevens and Senator William Roth (R-DE). Union opposition was assuaged with a promise that the language would be rewritten in the House-Senate conference committee. The bill ultimately passed through Congress via a legislative maneuver negotiated among Stevens, Roth, and their House counterparts, William Ford (D-MI) and Mary Rose Oakar (D-OH). Ford and Oakar recognized the necessity of reforming the pension system, as well as the danger of debating that legislation in the Democrat-controlled House. As a result, they proposed in the House a bill to rename a New Jersey post office—with the understanding that when that bill reached the Republican-controlled Senate, it would be amended to add the Senate bill language regarding the pension reform. This strategy sidestepped a potentially lengthy and bill-killing debate in the House. The bill easily passed the Senate (96-1), and suddenly the proposal for a revamped federal retirement system was in a House-Senate conference committee.[17]

Only two formal conference-committee meetings took place; most negotiation was done outside the meeting room. While the Reagan administration did not take an active part in the process, it was concerned about keeping cost as low as possible and ensuring that investments under the Thrift Savings Plan were kept out of politics. Over six months, the conferees rewrote the bill from scratch, keeping in mind the administration's concerns. The bill became law on May 16, 1986, and the president signed it on June 6. The new FERS went into effect January 1, 1987.[18]

That the new plan was an imperfect compromise is not surprising, given the process involved in enacting it. Some lawmakers wanted no change in the federal pension plan; others wanted no continuation of a DB program in any form. In between, the unions lobbied lawmakers in districts with large numbers of federal workers to get the best possible deal for their members. Said former Social Security chief actuary Robert J. Myers after the FERS bill became law, "What was missing most from the picture was the participation of organizations of persons representing the views of the real employer—the taxpaying public. The Executive Branch, through [the Office of Personnel Management] and [the Office of Management and Budget], should have played this role, but . . . largely abdicated responsibility."[19]

CSRS VERSUS FERS

FERS was mandated for all new employees, but existing employees were given the option of switching from CSRS to FERS. Thus FERS didn't fully replace CSRS; instead, it operated parallel to the older pension plan. But FERS was fundamentally different: In addition to a much-reduced DB plan, it added a DC component and Social Security coverage. The primary federal retirement plan, in effect, became two-tiered. CSRS would remain a low-risk program requiring little action from employees until it was eventually phased out, while FERS—which was aimed at newer, younger, and in some cases lower-paid employees and those who wouldn't necessarily remain in government service over the long term—would give workers more control over their retirement.

FERS encouraged employee mobility into and out of government with low basic employee contributions and portable benefits. Workers were covered under Social Security as well as a portable DC-style Thrift Savings Plan to which the government contributed a partial match of employees' elective contributions. (Workers also retained minimal coverage under a remaining DB portion.) The thrift plan was an integral part of the complete retirement package, as it was designed to compensate for the smaller DB pension. Through the thrift plan, workers would also take on more responsibility—and risk—for their retirements; and they could carry the savings with them to future jobs in the public and private sectors. Because it is optional, the Thrift Savings Plan requires workers to sign up for and contribute to it. A worker who does not sign up for the thrift plan foregoes the government's automatic 1 percent contribution and also its match of up to 5 percent of an employee's wages. Today, employees can contribute up to IRS limits for such DC plans. (In 2011, these limits were $16,500 for workers under fifty and $22,000 for workers age fifty and older.)

CSRS WOULD REMAIN A LOW-RISK PROGRAM REQUIRING LITTLE ACTION FROM EMPLOYEES UNTIL IT WAS EVENTUALLY PHASED OUT, WHILE FERS WOULD GIVE WORKERS MORE CONTROL OVER THEIR RETIREMENT.

FERS also gradually increased the minimum retirement age from fifty-five to fifty-seven. Beyond this, it encouraged older employees to continue working until age sixty-two by offering a higher benefit to those who remained on the job. Like many private retirement plans, it provided lower optional retirement benefits after ten years on the job, allowing, at least in theory, flexibility to plan retirement or make a career change. (For more details, see the sidebar "Provisions of CSRS and FERS.")

Benefits of remaining in CSRS included the ability to retire at fifty-five with full pension, a full cost-of-living adjustment, and credit for unused sick leave. While the two plans were designed to be as nearly equal as possible, at the most basic level CSRS was less complicated for employees, with retirement benefits based on a set formula rather than investment performance. The legislation did, however, allow workers covered under the CSRS the option of participating in the thrift program, although with no federal match. These were powerful incentives for current workers to remain in CSRS.

All new workers hired in 1984 and later were enrolled automatically in FERS. (Though it went into effect in 1987, the bill was retroactively applied to all employees hired after December 31, 1983.) Few existing workers chose to switch, however. The Congressional Budget Office had estimated that as many as 40 percent of those eligible would be better off under FERS—FERS and CSRS offered different benefits and drawbacks depending on a worker's specific situation and plans—but only about 2 percent of the eligible CSRS-covered workers actually changed plans.[20] Another transfer opportunity was offered in 1998 but, again, few employees jumped to the new plan, though under it many could in fact have been better off financially. (A few workers lost as much as $100,000 by not transferring.[21]) Still, the low adoption rate is hardly surprising. As usual, the employer—the government—was the driver of the pension switch, not the employees, and its primary incentive was to save money. Employees continued to have misgivings about new elements—like the Thrift Savings Plan—as well as mistrust of the Social Security system. "It looked like it was a good thing for younger people coming on. They got a chance to invest in what turned out to be a pretty good program," said Don Hostetter, a retired scientist with the Agriculture Research Service.[22] Hostetter, however, was too close to retirement for the program to look good to him and, like most employees near retirement, he choose to remain with CSRS.

Provisions of CSRS and FERS

Civil Service Retirement System

- Defined-benefit pension: Benefits are computed based on years of service and earnings. Employees are generally not covered by Social Security. Workers and their employing agencies each make matching retirement contributions to the basic retirement plan—generally 7 percent of earnings.
- Defined-contribution Thrift Savings Plan: Employees can participate in the plan with their own contributions up to IRS regulations (for 2011, workers under fifty could contribute no more than $16,500, and workers age fifty and above could contribute no more than $22,000), but employees receive no employer match.
- After retirement, benefits are indexed to the Consumer Price Index (CPI).

Federal Employees Retirement System

- Defined-benefit pension: Most employees contribute 0.8 percent of their salaries to a reduced DB pension plan, and agencies pay 11.7 percent of covered payrolls. The agency contribution was set to increase to 11.9 percent in October 2011.
- Defined-contribution Thrift Savings Plan: The employing agency contributes 1 percent of earnings to the DC thrift plan and matches employee contributions up to 5 percent of earnings. Employee contributions are limited by IRS regulations.
- Social Security: Social Security provides a base of retirement income and both employee and employer pay equally into the system. Normally, they each pay 6.2 percent of wages. (As an anti-recession measure, Congress temporarily reduced the employee amount for 2011.)
- After age sixty-two, benefits are adjusted annually by CPI minus 1 percent.

Many federal workers covered under FERS still look enviously at CSRS as the better deal. For employees covered by FERS, participation in and attention to the optional DC Thrift Savings Plan is vital, according to Tammy Flanagan of the National Institute of Transition Planning. In 2006, Flanagan analyzed the retirement benefit for an employee making $68,000 a year and found that the FERS benefit came out slightly ahead—$44,255 vs. $43,537 annually, assuming a 5 percent contribution rate to the thrift plan and an 8 percent return on investments.[23] (Of course, given the recent economic downtown, an 8 percent return now seems optimistic.)

THE NEW SYSTEM REQUIRES EMPLOYEE PARTICIPATION IN PLANNING AND SAVING, BUT IN EXCHANGE IT OFFERS POTENTIAL FOR A COMFORTABLE RETIREMENT WITH A PORTABLE PLAN TO SUPPLEMENT SOCIAL SECURITY.

Employees who switched from CSRS to FERS were more likely to be employed in human resources, Flanagan said. She believes those workers better understood the potential of a FERS retirement and were willing to be proactive in shifting, buying, and selling their stocks, bonds, and money markets. "Everyone has this feeling that FERS is inferior. It's not. I've done comparisons and they [employees in FERS] actually came out ahead because they managed their [thrift savings] account," said Flanagan, who conducts benefit seminars for federal employees.[24] The vast majority of workers in FERS do participate in the DC Thrift Savings Plan; though investment options were originally somewhat limited, they have since been expanded to offer employees investment opportunities in a government securities investment fund, fixed-income index investment fund, common stock index investment fund, small-cap stock index investment fund, and international stock index investment fund. Higher-paid workers are more likely to participate to the maximum amount allowed.[25]

FERS has been fully funded since its creation and appears to be financially stable in comparison to many other public and private plans. Determining whether FERS has saved the federal government money, however, is a difficult task. At the time of its implementation, FERS cost about 12 percent less per employee than CSRS. But changes in underlying economic assumptions—such as price inflation, changes in interest rates, and wage and salary increases—have led to significant revisions of the estimated cost of CSRS. Thus while the cost of FERS has remained relatively constant, CSRS now appears to be less expensive than it once was, rendering FERS the more expensive plan.[26] To further complicate this picture, since FERS and CSRS are run together, FERS must eventually cover CSRS shortfalls. In due course, the CSRS account will develop a shortfall as fewer and fewer CSRS-covered workers remain on the job, and FERS then will begin to cover CSRS benefits. That scenario remains in the future, however: As a whole, FERS took in about $28 billion more than it paid out in benefits in 2010, according to the government.[27]

CONCLUSION

A quarter century in, FERS is on the way to completely supplanting CSRS's cookie-cutter, one-size-fits-all approach to retirement. In its early years, FERS struggled to attract existing workers who were already enrolled in CSRS, but it is estimated that FERS will cover 95 percent of all federal government employees by

2015. The new system requires employee participation in planning and saving, but in exchange it offers potential for a comfortable retirement with a portable plan to supplement Social Security. Thus federal workers do not have to feel confined to government careers. (The benefit of portability has provided added importance to FERS in light of federal agency cutbacks and associated layoffs of workers, especially since the economic downturn in 2008.) In addition, the federal government still offers new employees a DB element, something fewer and fewer companies offer workers.

Fundamental reform of the federal government's pension plan took months of negotiation preceded by years of change in the pension and budgetary landscapes. If not for the gradual inclusion of more and more federal workers in Social Security, reform might not have been rendered necessary. Even then, it took fiscal woes associated with economic recession to override political differences enough to allow for compromise on the proposal—and some legislative hocus-pocus to move the proposal past the Democratic House. The result was a more modern plan. Still, it was an imperfect compromise, one that retained aspects of the CSRS plan it was intended to replace while leaving many employees under the new plan longing for the benefits of the old.

In 2011, we find ourselves in similar economic straits and, once more, with a divided government. Again, there are calls to reform the pension plan for federal workers. Economics and trillion-dollar federal budget deficits are catching up with FERS. While FERS is presently running a surplus, a bleak financial outlook has exposed it to calls for change—particularly because the federal government, through its various departments and agencies, must continue to fund the DB pension portion of the program. Monumental federal budget deficits have incited calls for workers to shoulder more of their retirement through increased employee contributions as one way to reduce the government's costs. In 2010, a presidential commission recommended equalizing employer and employee contributions to the FERS DB plan. This would increase the employee contribution rate to 5.8 percent (from 0.8 percent), a proposal critics likened to a 5 percent pay cut. The change would save an estimated $117 billion over ten years and $300 billion over twenty years, according to the nonpartisan think tank Third Way, which originally proposed the idea in 2010.[28] The commission also recommended changing the formula for calculating retirement benefits to reduce pensions, and deferring cost-of-living adjustments for retirees until age sixty-two.[29] Even with these changes, FERS would remain a relatively good but expensive plan, hence a proposal in the U.S. Senate in 2011 to eliminate the DB portion for all new hires after 2012.

If the federal government wades again into the turbid waters of pension reform, it would do well to learn from its prior experience. Reform was palatable to unions because existing employees were allowed to remain in the existing plan. At the same time, the new plan instituted overlapping elements—a DB portion, a DC-style Thrift Savings Plan, and Social Security—to make the reform more attractive for workers (though many still preferred CSRS). Still and all, few organizations looking to revamp their pension plans face as many challenges as the federal government, and the simple fact that it was able to accomplish this, however imperfectly, carries lessons that others should take to heart.

[1] Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in the United States, March 2010* (Washington, D.C.: U.S. Department of Labor, 2010), 350, http://www.bls.gov/ncs/ebs/benefits/2010/ebbl0046.pdf.

[2] Richard G. Schreitmueller, "The Federal Employees Retirement System Act of 1986," *Transactions of the Society of Actuaries* 40, no. 1 (1988): 557, http://www.soa.org/library/research/transactions-of-society-of-actuaries/1988/january/tsa88v40pt119.pdf.

[3] Tammy Flanagan, "Retirement Planning: CSRS vs. FERS," National Institute of Transition Planning, March 31, 2006, http://www.govexec.com/dailyfed/0306/033106rp.htm.

[4] Olivia S. Mitchell and Edwin C. Hustead, eds., *Pensions in the Public Sector* (Philadelphia: University of Pennsylvania Press, 2000), 68.

[5] Patrick Purcell, *Federal Employees: Pay and Pension Increases Since 1969* (Washington, D.C.: Congressional Research Service, 2010), http://assets.opencrs.com/rpts/94-971_20100120.pdf.

[6] Schreitmueller, "Federal Employees," 544.

[7] Most state employees have Social Security protection because their states and the Social Security Administration entered into special agreements called Section 218 agreements. Others are covered by a federal law approved in 1991 extending Social Security to state and local employees who were not covered by an agreement and were not members of their agency's public-pension system.

[8] Wilmer L. Kerns, "Federal Employees Retirement System Act of 1986," *Social Security Bulletin* 49, no. 11 (1986): 5–10, http://www.ssa.gov/policy/docs/ssb/v49n11/v49n11p5.pdf.

[9] Schreitmueller, "Federal Employees," 544.

[10] Ibid., 545.

[11] Kerns, "Federal Employees Retirement System Act," 5–6.

[12] Schreitmueller, "Federal Employees," 547.

[13] The idea of pension reform also got a push from President Reagan's Private Sector Survey on Cost Control, popularly known as the Grace Commission, which recommended lower pensions for civil servants in a retirement plan coordinated with Social Security.

[14] Schreitmueller, "Federal Employees," 557.

[15] Michael R. Virga, discussion of "The Federal Employees Retirement System Act of 1986," *Transactions of the Society of Actuaries* 40, no. 1 (1988): 605, http://www.soa.org/library/research/transactions-of-society-of-actuaries/1988/january/tsa88v40pt119.pdf.

[16] Jamie Cowen, *Twenty-Five Years after Federal Pension Reform* (Washington, D.C.: Employee Benefit Research Institute, 2011), http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=4837.

[17] Ibid., 11–12; and Schreitmueller, "Federal Employees," 552.

[18] Cowen, *Twenty-Five Years After*, 14.

[19] Robert J. Myers, discussion of "The Federal Employees Retirement System Act of 1986," *Transactions of the Society of Actuaries* 40, no. 1 (1988): 606, http://www.soa.org/library/research/transactions-of-society-of-actuaries/1988/january/tsa88v40pt119.pdf. Myers helped design the original Social Security program and served as the program's chief actuary.

[20] Schreitmueller, "Federal Employees," 597.

[21] Mitchell and Hustead, *Pensions in the Public Sector*, 70.

[22] Author's interview with Donald Hostetter, February 2011.

[23] Flanagan, "Retirement Planning."

[24] Author's interview with Tammy Flanagan, February 2011.

[25] Ibid.

[26] Cowen, *Twenty-Five Years After*, 17–18.

[27] In late 2010, the FERS trust fund contained $775 billion of U.S. Treasury securities, equal to about 6 percent of the total national debt at the time. Coming as it does from federal agencies, much of the FERS revenue came as a result of government borrowing. Of the system's $28 billion in income, only about $4 billion was in cash. This surplus prompted the U.S. Postal Service to point out that it had been overpaying billions of dollars into the federal retirement fund. The Post Office wanted to reduce its payments and use the money for operations. In early 2011 the White House agreed. President Obama's proposed budget would reimburse the Postal Service for $6.9 billion in overcharges for FERS retirees, with the payments to be spread over thirty years and with a $550 million payment in 2011.

[28] David Kendall and Jim Kessler, *Frequently Asked Questions about Federal Retirement Reform* (Washington, D.C.: Third Way, 2011), http://content.thirdway.org/publications/405/Third_Way_Memo_-_Frequently_Asked_Questions_about_Federal_Retirement_Reform.pdf.

[29] Stephen Losey, "5 Percent Pay Cut on the Table: How Increasing Your Retirement Contribution Would Affect Your Pension," *Federal Times*, May 23, 2011, http://www.federaltimes.com/article/20110523/BENEFITS02/105230301/; and "Debt Commission Proposes Changes in Retirement Calculations, Health Benefits (FEHB) and Pay Freezes for Federal Employees," My Federal Retirement, December 2, 2010, http://www.myfederalretirement.com/public/775.cfm.

II. Making Change in Utah and Alaska

The recession that began in 2008 hammered both private- and public-pension plans. A few years earlier, few pension plans seemed to pose any great threat to state budgets, and pension-fund managers were able to skirt public scrutiny and make assurances that everything was fine—despite the unfunded liabilities already burdening almost all public funds. But with the financial meltdown, billions of dollars evaporated overnight. Public plans, already performing poorly, found themselves much worse off after the financial dust settled. State lawmakers, pension-fund managers, and taxpayers could no longer ignore the dire state of public-pension expenses.

But while the market crash caused much hand-wringing, it has, to date, brought about little fundamental change in the public-pension sector. A number of states took action to increase contributions to their pension plans, raise the retirement age, and/or fiddle with benefit formulas, but these actions merely nibbled around the edges of a gigantic problem.[1] Though traditional defined-benefit (DB) plans have long been out of step with private-sector offerings, public employees and their unions have resisted any reforms that increase employee contributions and place greater responsibility for risk on the employee's shoulders. In the face of serious, looming threats to DB plans, opponents of pension reform have only grown louder.

Still, a few states have taken decisive action to right failing pension systems. Nebraska was decades ahead of the rest of the nation when it shifted its state-employee pension system (which excludes teachers, who participate in a separate plan) to a defined-

Real Change is Rare

Only three states have switched from DB plans to mandatory, pure DC plans for new state employees: Alaska, Michigan, and Nebraska. Of these, only Alaska included teachers in the switch, and its decision and experience are explored in the latter half of this case study. Nebraska alone took the additional step of converting its DC plan into a cash-balance plan for new employees. Today, the vast majority of state pension systems remain DB plans, although many states have introduced some type of optional DC add-on or other alternative.

In 1967, Nebraska was the first state to freeze its DB plan for existing state employees (excluding teachers, judges, and state police) and mandate a DC plan for all new workers. Existing employees were allowed the option of remaining in the DB plan or choosing the DC plan. But because the DC plan produced smaller retirement benefits for general state workers than the DB plan did for those workers excluded from the change, Nebraska froze its DC plan in January 2003 and enrolled all new employees (again excluding teachers, judges, and state police) in a cash-balance plan. Existing employees were again allowed the option of switching to the new plan.[2]

Michigan legislators mandated a DC plan for new state employees—excluding teachers—in 1997. In 2010, legislators extended pension reform to include teachers and other school employees, requiring those hired after July 1, 2010, to enroll in a hybrid DB/DC plan. The new plan also raised the minimum retirement age and years-of-service requirements for the DB portion.[3] Employees can contribute to the DC plan up to IRS limits. (In 2011, these limits were $16,500 for workers under fifty and $22,000 for workers age fifty and older.) They also may choose not to contribute at all, in which case they will not receive the employer's 1 percent match.[4]

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While real and enduring change is indeed rare, some places see more activity than others—though those changes are not always improvements. In West Virginia, for example, pensions for teachers have switched back and forth between DC and DB plans for decades. The state first instituted a DC plan for teachers in 1941. Gradual modifications throughout the 1960s—such as ensuring a minimum benefit—eventually converted it into a more traditional DB plan by the 1970s. But the plan was not actuarially funded; the state took a pay-as-you-go approach to its contributions, addressing costs only as they were incurred and failing to set aside money to fund accrued liabilities for the future. This approach, combined with increases in benefits, left the pension fund with a $5 billion unfunded liability by 1990. As a result, lawmakers closed the DB plan to new teachers in 1991 and replaced it with a DC plan. A decade later, many teachers found that the new plan did not produce adequate retirement income. Blame fell on unpredictable markets and a lack of information about investment options and returns. Faced with the prospect of supporting scores of retired teachers with insufficient retirement income on Medicare and welfare, the state passed a new law in 2008 that allowed teachers to vote on whether they wanted to return to the DB system; they overwhelmingly chose to do so. Because of the low state contribution to the DB plan, the move is expected to save the state $1.4 billion by 2034; still, West Virginia's pension plan remains vastly underfunded.[5]

Lawmakers in states particularly hard hit by the recession continue to examine both DC plans and cash-balance plans, but some states do so for reasons unrelated to finance. Georgia, for example, created a hybrid plan in 2008 to attract new, young workers who might not plan to work for the state their entire careers and might therefore prefer a portable pension plan.[6]

contribution (DC) plan in the 1960s (see the sidebar "Real Change is Rare"). Michigan switched to a DC plan in 1997 for general state workers (also excluding teachers). Utah, in direct response to the global financial crisis, presented state workers—including public-school teachers—with the option of choosing between a DC plan and a hybrid DB/DC plan. (Hybrid plans are fairly common but, as described in the following pages, Utah's included a significant twist that has attracted national attention.) Alaska was even more proactive. It changed its pension system before the crash by ordering all new state employees, including new teachers, into a mandatory DC plan. This case study investigates pension reform in both Utah and Alaska, as those two states both included public-school teachers in their pension reforms. In particular, we examine the budgetary pressures that demanded change, the political environments that made change possible, and, in the case of Alaska, attempts to roll back that change.

UTAH'S INNOVATIVE HYBRID PLAN

The financial crisis of 2008 resulted in a $6.5 billion unfunded liability in the Utah Retirement Systems (URS). Instead of earning the expected rate of return of 7.75 percent on its portfolio in that year, the state pension fund lost 22 percent of its worth (see the sidebar "Why Rates of Return Matter"). On top of that, benefit costs continued to increase due to cost-of-living adjustments and higher benefits for newer, higher-paid retirees. Ultimately, the pension fund amounted to about 30 percent less than what was needed to meet future obligations, according to the state. Simply earning more on investments in future years would not be enough to pull Utah out of this hole: The URS estimated the plan would need to average double-digit returns (far more than 7.75 percent, which was likely unrealistic even without the recession) each year for more than two decades to recoup.[7]

Facing such bleak financial prospects, Utah chose to alter its plan and introduced new legislation that would require public employees hired after July 1, 2011—including teachers—to choose between (1) a straight DC plan and (2) a hybrid plan with DB and DC components. Existing workers could remain in the traditional DB plan or opt for one of the two new plans.[8]

"Risk containment was very much on our minds," says Dan Liljenquist, a state senator who chairs the senate's retirement committee and who sponsored the new retirement legislation. "With investment losses, our costs would have gone from $400 million to $800 million a year. We had to look at what we could afford, and what it could buy."[9]

As with Uncle Sam's shift to a hybrid plan in 1986 (see Chapter I), existing state employees resisted the change throughout the legislative process. Educators, law enforcement officers, and public employee unions and organizations actively opposed the reform proposal. A rally at the statehouse drew four thousand labor protesters. Utah Education Association president Kim Campbell told the crowd that changing the retirement plan would hurt teacher recruitment. "If Utah really wants to attract and retain the best teachers, school staff, policemen, and state employees, we cannot continue to cut their compensation," Campbell said. "We know that defined-benefit retirement systems are an effective recruitment and retention tool."[10]

Labor groups argued for a year-long moratorium on legislative action in order to study alternatives.[11] They also threatened to defeat any lawmaker who voted for pension change.[12] Lawmakers ultimately ignored the request for a moratorium but, following a typical pension-reform model, they sought to soften objections by ensuring that the legislation would apply only to new workers. While unions still objected to the plan—knowing that protecting benefits is one of the foremost jobs of unions—they did not object as vociferously as they likely would have if the law had affected current workers. Bolstered by taxpayer support, Republicans passed the law in 2010.

WHILE UTAH'S PENSION REFORM IS STILL IN ITS INFANCY, THE PLAN IS BEING HAILED AS A POTENTIAL MODEL FOR OTHER STATES.

Taxpayers continued to show their support for the legislation and the lawmakers that championed it well after the law was passed. The reform effort received significant public attention, and voters largely recognized the fiscal urgency that prompted the reform. "Not a single Republican who voted for the reforms lost [in the next election], and the GOP picked up seats," the *Wall Street Journal* noted in an editorial. "From now on in Utah, tax increases or spending cuts for schools, parks, or roads won't be necessary to make legally required payments to retired state workers."[13]

Structure of Utah's New Plan

While Utah's pension reform is still in its infancy, the plan is being hailed as a potential model for other states. Under the traditional DB plan, employer contributions in the Beehive State ranged from 13.4 percent to 16.3 percent of salary in 2010–11, depending on the type of state or local government employee, and employees made no contributions into the plan. (The state contributed at even higher rates into the pensions of public-safety workers, judges,

Why Rates of Return Matter

Most states use an unrealistic rate of return to estimate future portfolio values and benefits. Alaska assumes an average return on investment of 8.25 percent. Utah assumes 7.75 percent. Almost every state pension fund assumes an average return on investment of around 8 percent.[14] Yet experts agree that such figures are unrealistic, given the 2008 economic downturn, and that they egregiously understate unfunded liabilities by overestimating the available future funds. Both the American Legislative Exchange Council and the Pew Center for the States have deemed the 8 percent expected return rate unrealistic.[15]

In contrast, private-pension funds base their benefits on returns of about 5 percent or less. Over the decades, that difference amounts to many billions. Jay Greene, chairman of the Department of Education Reform at the University of Arkansas, has pointed out that it makes the most sense to gauge growth, and benefit payments, on the risk-free but lower rate of long-term U.S. Treasury bonds. But basing benefits on U.S. Treasury instruments, the safest form of investment, would put most pension funds into bankruptcy unless they vastly increased employer and employee contributions or cut benefits.[16]

and legislators. In addition, a small number of state and local government employees participated in a contributory DB plan to which the state contributed between 9.4 and 11.8 percent of salary, and employees contributed 6 percent.)[17] Workers hired before July 1, 2011, could opt to remain in the traditional DB plan.

Under the new plan, the public employer contributes 10 percent of a new employee's salary into either the DC plan or the hybrid plan, whichever the employee has chosen. If the 10 percent contribution is inadequate to meet the defined benefit under the hybrid plan, *the employee has to make up the difference*. In other words, the state's contribution is capped at 10 percent of payroll.[18]

If an employee chooses the hybrid plan, the employing agency deposits any amount of the 10 percent contribution not needed for the DB portion into the DC portion; employee contributions to that DC portion are optional. In effect, the state subsidizes the employee's DC plan when the DB plan is exceeding expectations; otherwise, the employee is the only contributor to the DC plan. The new plan makes other changes, including increasing the number of years that employees, including teachers, must work before retiring, regardless of age.[19] "Ten years from now," says Liljenquist, "we should be able to absorb any economic hit. We'll be in great shape in twenty years, and in thirty, we'll have removed any risk of state bankruptcy."[20]

Current employees see different pros and cons related to choosing a new plan or remaining in the traditional plan. Casey Parry, a thirty-two-year-old research consultant in the state's human resources department, said he preferred a DC option: "It's hard when you're starting a job to make a decision whether to stay with an employer for thirty years. I prefer the security of having a defined-contribution plan that I know I can take with me. It's under my control. I can plan for it." However, another employee, a health insurance policy analyst who has worked for the state for thirty-five years, said she preferred the traditional plan, especially after the stock market crash of 2008.[21]

Utah as an Example for Other States

The new Utah plan has garnered much attention, both for its innovative design to cap state costs and for the public support that the plan has received. Liljenquist has become the point man in explaining the change to officials of other interested states. By July 2011, the month the plan took effect, Utah had received inquiries from eighteen states. For taking action to avert a budget crisis, both the state of Utah and Liljenquist were recognized by State Budget Solutions, a nonpartisan organization studying fiscal reform.[22]

But while the new plan is expected to save Utah money on new hires, it doesn't affect the state's unfunded liability for those already enrolled in the existing DB plan. More than likely, Utah public employers will have to increase their contributions to the existing DB plan in order to expunge unfunded liabilities; whether or not these increases will be required anytime soon is another question. As the hybrid plan just started this past summer, it is too soon to measure the benefits—or identify the shortfalls—of the new system in any quantitative way. Cutting future liabilities and reducing the state's investment risk by passing it to employees are positive steps for state budgeters and taxpayers alike. But how well those steps work to reduce Utah's unfunded pension liability for its original DB plan depends very much upon future investment returns. Poor investment portfolio performance still has the potential to wreak havoc on the DB portion of the state plan.[23] And whether the plan produces an adequate return for future retirees is also a matter of how employees fare in the stock market.

ALASKA'S PLUNGE INTO UNCHARTERED WATERS

While Utah opted for a state pension system that allows public employees to choose between a pure DC plan and a hybrid plan, Alaska's reforms went further, mandating a DC plan for all new state workers—including teachers. In 2005, the state converted its traditional DB plan to a DC plan funded by both employee and employer. As in Utah, some lawmakers in Alaska feared the state pension fund's growing liability and therefore moved to shift retirement responsibility from state taxpayers onto new public employees and current employees who opted into the new plan. "The state was no longer able to keep up with the unfunded liability of the defined-benefit plan," said Lyda Green (R-Wasilla), a state senator who was a member of the State Affairs Committee and former president of the senate.[24] Few could deny that Alaska's pension fund had abruptly deteriorated. While assets and liabilities matched in 2001, a year later—well before the 2008 economic downturn—they were badly misaligned.[25]

Understanding Alaska's situation must commence with a look at the state's pension history. Thirty years ago, the North Slope oil boom brought the state a seemingly inexhaustible flow of income. With its coffers bulging, Alaska eliminated taxes and boosted retirement benefits to attract and retain public workers. It also began to hand out annual checks to every state resident. Alaska soon became known for its "gold-plated" public retirement plan, which was considered so good the state didn't need to be in the federal Social Security system.

By the 1980s, however, lawmakers were fretting that Alaska's generous benefits were growing too costly. In 1986, they partially restructured the pension system in an attempt to minimize future financial impact, increasing the age of full retirement from fifty-five to sixty, among other changes. But these modifications only deferred the problem: By 2002, the state's unfunded liability for both its general public employees, under the Public Employees' Retirement System (PERS), and for teachers, under the Teachers' Retirement System (TRS), had ballooned to $4.2 billion combined. By 2005, the combined figure had grown to $6.9 billion.[26]

Alaska is generally a Republican state, but years of Republican dominance have produced shifting alliances within that party and with Democrats that sometimes make for unusual politics. Republican in-fighting in the 1990s even led to the election of Tony Knowles, a Democrat, as governor. This shifting political landscape delayed attempts at pension reform. Some Republicans had wanted to alter the state pension plans for years leading up to the turn of the century. By the mid-2000s, that idea had gained some momentum, but abandoning the state's DB plan altogether remained controversial among GOP members. Reform couldn't proceed until pro-reform Republicans had marshaled enough Democratic support to allow for some GOP defections.

In 2005, Republican legislators introduced Senate Bill 141, which would enroll all new employees in a pure DC plan. That bill caught employee organizations off guard and was approved in the Senate before opposition could organize. Scrambling, opponents halted the bill in the House, but only momentarily; the legislation was subsequently approved by a one-vote majority during a special legislative session called by Governor Frank Murkowski. (Special sessions are fairly common in Alaska because of limitations on how long the legislature can meet in regular session. The retirement-plan change was made as lawmakers approved a batch of important bills in a last-minute effort to get things done.)[27]

SAVINGS FROM A SWITCH FROM A DB TO DC PLAN TAKE TIME TO ACCUMULATE, ESPECIALLY IF A PUBLIC EMPLOYER HAS TO PROP UP THE REMAINING DB FUND FOR EXISTING EMPLOYEES TO COMPENSATE FOR THE LACK OF NEW EMPLOYEES ENTERING THAT PLAN

The new plan, which covers all new state and almost all new municipal workers, including teachers, took effect in July 2006. It resembles a private-industry 401(k) plan: Both employees and employers contribute to it, and the worker is responsible for all risk associated with account performance. The state administers the investment options—employees can choose among stock funds, bond funds, and money market funds—and provides counseling, but employees ultimately make the investment decisions and enjoy (or lament) the end result. Employee contributions vest immediately, but employer contributions are 25 percent vested after two years, 50 percent vested after three years, and 75 percent vested after four years. After five years, workers can take their employer's full contributions with them if they leave state employment.[28]

Backlash to the DC Plan

Switching from existing pension systems to DC plans or DC variants is emotionally and politically charged, in no small part because many employees do not feel qualified to direct their retirement portfolios and worry about making poor investments. Critics of such switches also point to increased costs in the short run—costs resulting from propping up lingering DB portions that suffer from a lack of new member contributions. It comes as no surprise, then, that the new plan's opponents in Alaska have not stopped fighting it.

Calls to scrap the DC plan and return to the previous DB program grew in intensity after the stock market decline in 2008. Opponents of the new plan argued that the problems it attempted to fix had already been solved; today's unfunded liabilities, they said, carried over from the high costs of earlier versions of the DB pension plan, and that these had already been addressed through multiple revisions of that plan (see the sidebar "Alaska's Multitier Retirement System"). They argued that the new DC plan was not only unnecessary, but that it actually added to the unfunded liability, as no new employees would contribute to the DB plan that remained in effect for existing employees.[29] To be sure, savings from a switch from a DB to DC plan take time to accumulate, especially if a public employer has to prop up the remaining DB fund for existing employees to compensate for the lack of new employees entering that plan. So while the DC plan may save the state money in the future, opponents of the new plan were correct in lamenting the additional short-term costs: By 2009, Alaska's liability for its existing DB plan had reached nearly $10 billion, according to state estimates.[30] (Of course, this growth was partially due to the economic recession.) In fact, pension obligations alone are the single largest debt owed by Alaska, where overall debt amounts to 70 percent of the state's gross domestic product—the highest proportion in the nation in 2010.[31] "We're looking at a requirement for significant appropriations

Alaska's Multitier Retirement System [32]

Alaska's retirement system is comprised of two main plans—the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS). Retirement programs for the two plans have undergone numerous alterations, as lawmakers have attempted to match the plans with budgetary realities, and their present workings manifest these layers of changes. PERS now consists of four plans (or tiers) that are tied to an employee's hiring date. TRS has three tiers. The final tier in each system represents the new DC plan. Below, we describe the tiers for PERS to reveal how the system has gradually been tightened.

Tier 1 covers employees working as of June 30, 1986. Pensions and medical coverage vest after employees have five years on the job. The normal retirement age is fifty-five, with early retirement at age fifty. The retirement system pays medical premiums, even for early retirees.

Tier 2 covers employees hired between June 30, 1986, and June 30, 1996. Pensions and medical coverage also vest after five years. The normal retirement age is sixty, with early retirement at age fifty-five. The retirement system pays medical premiums starting at age sixty.

Tier 3 covers employees hired between June 30, 1996, and June 30, 2006. Pensions vest after five years and medical coverage after ten. Normal retirement is at age sixty, with early retirement at fifty-five. The retirement system pays medical premiums at age sixty so long as the worker has provided at least ten years of service.

CONTINUED ON PAGE 30

Tier 4 covers employees hired after June 30, 2006. No defined benefit is offered. Employees and employers pay into a DC investment fund, at mandatory rates of 8 and 5 percent of salary, respectively. (Employees can make additional contributions up to IRS limits, which were $16,500 for workers under fifty and $22,000 for workers age fifty and older in 2011.) Employee contributions vest immediately and employer contributions are 25 percent vested after two years, 50 percent vested after three years, 75 percent vested after four years, and 100 percent vested after five years. Medical coverage is provided at age sixty-five if the worker has put in at least ten years of service; but the retiree must pay part of the premium. To qualify for postretirement medical coverage, the retiree must retire directly from the state system as opposed to leaving the system to work somewhere else. Younger retirees can get medical coverage after thirty years of service (twenty-five years for police and firefighters) but they must pay full premiums if not they are not Medicare eligible.

to the PERS and TRS funds to pay down this unfunded liability," said Kevin Brooks, deputy commissioner of Alaska's Department of Administration, in 2010.[33]

That Alaska's public employees do not participate in the Social Security system is also fodder for critics of the new plan. Those critics argue that, because of this arrangement, those under the DC plan are left with no safety net if their investments do not perform well; on the other hand, a DB plan guarantees a worker a set benefit amount. A bill introduced into the Alaska senate April 2011, which gives employees a choice between a DB and DC plan, is based in part on this argument. (The bill is set for hearings in September and October 2011.)[34]

Critics also complain that the new plan drives away experienced state workers and renders recruitment more difficult. Jake Todd, a twenty-five-year-old Anchorage teacher, travelled to Juneau in 2008 to lobby lawmakers to dump the new plan. He said that the new 401(k)-style retirement plan doesn't effectively recruit *or* keep teachers in Alaska, mostly because teachers have to become investment experts to ensure themselves a good retirement. "I'm not a financial planner, and I don't really care to be one," he said.[35] But Kevin Brooks, then deputy commissioner of the Alaska Department of Revenue, countered that recruitment had not been rendered more difficult by the change. "We just implemented this defined-contribution plan about twenty months ago," he said. "We've heard a lot of anecdotal evidence that it's affected recruitment, but we're continuing to hire people." Brooks said that turnover may have been due to a multiyear freeze in cost-of-living adjustments to state salaries.[36] One of the key unknowns is how many workers may leave their jobs and the state as they begin to become fully vested in 2011.

Alaska's Uncertain Pension Legacy

Today, the effort to roll back the DC plan and implement a DB system has strong support. Most of this support comes from Democrats in the statehouse, though some is from Republicans. But while the pension system's unfunded liabilities continue to grow, the state budget itself remains largely secure, continuing to benefit from oil revenue. Despite a general desire on the part of the legislature to tighten the state's belt, Alaska is one of the few states that—because of its massive flow of oil revenue—does not require a balanced budget. In some years the state runs a surplus, in other years a deficit. In recent years, however, there have been more surpluses because of a sharp increase in oil prices and in the oil-production tax pushed through the legislature by then-governor Sarah Palin. Currently, the state has about $40 billion in its Alaska Permanent Fund, which allows it to send an annual dividend check to every state resident. This year the checks were for $1,281. The oil wealth also allows the state to operate without a state income tax, state sales tax, or state property tax, although some localities do have taxes. Alaska also has about $11 billion in the bank to balance future budgets.[37] So while opponents of the new plan can point to looming unfunded liabilities on the horizon, Alaska does not face the immediate threat of massive budget cuts to backfill its pension obligations—a threat that many other states are confronting today. Alaska's unique situation creates a distinct testing ground for pension reform, to be sure; the state can both amass greater debt than other states (and it has, as discussed earlier), and delay addressing that debt for longer, because it has greater income. At the same time, Alaska's transition to a DC plan carries with it universal lessons for other states considering pension reform.

Alaska's DC plan will eventually help the state cut liabilities, but it may take decades to pay off in full the lingering costs of the DB portion that remains in place for existing employees. In the absence of massive budgetary reserves, other states considering a switch from a DB to a DC plan will need to grapple with how to contain those rising costs in the short run—perhaps by instituting a hybrid plan similar to Utah's. Given the backlash to the Alaska switch, many states may find that a switch from a DB to DC plan is simply not feasible—fiscally or politically—in the current economic climate. Ron Snell, pension expert at the National Conference of State Legislatures, predicts that, while many legislatures will *consider* the switch to DC plans, they won't ultimately follow through.[38]

One immediate and positive aspect of Alaska's reform that other states should not ignore, however, is that the switch transferred investment risk from the state to its employees; the state can now better estimate its future costs, and it will not bear responsibility for infusing the plan with cash during years of poor investment returns—a significant advantage in years of recession. The importance of this element of pension reform cannot be overstated. States contemplating switching to DC plans should *consider* that, while such reform may be a tough pill to swallow, it is better done sooner than later.

CONCLUSION

The paths of pension reform taken by Utah and Alaska are somewhat different, but they share a similar origin: In both states, benefits were promised and delivered based on pension-fund investment income that would never be realized. Because those pension funds could not invest their way out of the deficit pothole, both states decided not to tweak the existing plans but to create new plans under which employees shoulder greater cost and risk. Both states now must wait to see how those plans pan out in the long run.

Utah's hybrid plan wisely caps state spending. But exactly how beneficial this cap will prove for the state's coffers won't be known for years. Even with the cap, savings will remain small in the short term. Whether the state can successfully reduce its future liabilities will depend, at least in part, on national and state economics and investment-market returns—factors outside the state's control. In addition, whether the new system actually yields a decent retirement and can avoid further modification (unlike Nebraska's system) also will not be known for years. (For an example of a public DB-to-DC change that has produced fairly immediate savings, see Chapter III.)

Alaska's introduction of a pure DC plan for new workers went further but will not likely be followed by many other jurisdictions unless it proves dramatically successful. Nevertheless, in the decades to come, Alaska's new plan should accomplish two very important goals—reducing the state's exposure to future financial meltdowns and their accompanying disastrous effects on unfunded pension liabilities, and making future contributions to employee retirement accounts predictable and easier to plan for. These two considerations are not to be taken lightly.

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[4] "FAQs," Office of Retirement Services, Michigan Public School Employees Retirement System, http://www.mipensionplus.org/faq.html.

[5] Over seven years ending in 2007, annual returns of teachers in West Virginia's DC plan trailed those of teachers in its DB plan by 69 percent. Chuck Burnham, *Legislative Research Report: States Reverting from Defined Contribution Retirement Plans* (Juneau, AK: Alaska State Legislature, 2009), http://www.legis.state.ak.us/BASIS/get_documents.asp?session=26&docid=2058; and Judy Ward, "State Plan Sponsor of the Year: A Lesson in Funding," *PLANSPONSOR*, March 2009, http://www.plansponsor.com/MagazineArticle.aspx?id=4294990027.

[6] For more information on the Georgia hybrid plan, see Employees' Retirement System of Georgia, *Explanation of Benefits 2009* (Atlanta, GA: Employees' Retirement System of Georgia, 2009), http://www.ers.ga.gov/plans/ers/formspubs/ERS_Handbook_06302009.pdf.

[7] "Utah Retirement System Reforms—Frequently Asked Questions," Utah League of Cities and Towns, 2010, http://www.ulct.org/ulct/docs/retirement/URS_Reforms_FAQs.doc.

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III. Oakland County, MI: Poster Child for DC Plans

Despite the deficits, budget cuts, and other fiscal distress that beset nearly all of them, most local governments have hesitated to move away from traditional defined-benefit (DB) pension plans in the face of employee reluctance and intense union opposition. All the more noteworthy, then, is the handful of prominent exceptions: government units that have willingly and successfully transitioned from traditional public-sector DB plans to defined-contribution (DC) plans and other alternatives. Here we examine Oakland County, Michigan, which completed such a transition notable for its fiscal soundness and lack of employee agitation.

OAKLAND COUNTY AND ITS UNIONS ENGAGED IN STRAIGHTFORWARD AND REALISTIC NEGOTIATIONS THAT, RATHER THAN PROLONGING AN ANGRY DEBATE, MINIMIZED REVISIONS TO THE PROPOSED REFORM WHILE RENDERING THE FINAL PROPOSAL PALATABLE TO ALL SIDES

A relatively prosperous suburban realm within the Detroit metro area, Oakland County instituted a pure DC plan in 1994. It used many of the same techniques in its transition—above all, keeping workers abreast of the reasons for change and the specifics of the new plan—that have been used by the other successful pension reformers examined in this volume. But the county's functional relationship with its labor unions stands out as an additional notable contributor to its relatively painless changeover: Oakland County and its unions engaged in straightforward and realistic negotiations that, rather than prolonging an angry debate, minimized revisions to the proposed reform while rendering the final proposal palatable to all sides. Oakland County's successful and money-saving switch is considered by many to be a lesson in well-managed public-pension reform.

RECOGNIZING THE NEED TO CHANGE

Oakland has a population of about 1.2 million people. Though historically one of the country's most prosperous communities, it has sustained many job losses over the last few decades, due mainly to the decline of the Michigan auto industry.[1] The nationwide economic downturn that began in 2008 has also had a damaging effect on local prosperity, though it came long after Oakland County's initial step toward pension reform in 1994. Real estate prices were dropping before the recession but collapsed by an additional 35 percent between October 2006 and October 2009. By June 2010, unemployment in Pontiac, the county seat, reached 31 percent—higher than in Detroit itself.[2] These dismal circumstances, in addition to property-tax restrictions introduced into Michigan's tax code in the late 1970s and early 1990s, diminished local government income and, in Oakland County, prompted further modifications to the pension reform that had begun fifteen years earlier.

In the old days, Oakland County operated a self-contained, well-funded, traditional DB plan for its public-sector workers, who were organized into fourteen different collective-bargaining units. That plan paid benefits equal to 2 percent of an employee's average salary over the last five years of employment, multiplied by total years of employment. Employees were not required to contribute to it. Also provided by the county were an optional deferred-compensation plan and retirement medical benefits.[3]

Even though it was well-funded, a major uncertainty of the old plan was that it did not require employees to contribute, placing the entire onus for keeping the plan solvent on the county. With naturally fluctuating investment returns, the county was not able to predict what its contributions would be from one year to the next. As one county executive put it, a municipality "cannot continue to operate a governmental unit without knowing what . . . retirement costs will be" each year.[4] In addition, the county's limited property-tax revenue base made mounting wage, medical, and retirement costs matters of increasing concern, and county officials sensed that their pension plan would grow too expensive in the long term. Going forward, legacy costs—obligations incurred today for current and future retirees, to be paid in the future—were of particular concern, and needed to be addressed in order for the county to achieve fiscal stability. (For further discussion of pension reform when a plan is well-funded, see the sidebar "Pension Reform, in Good Times and in Bad.")

Oakland County's retirement-plan transition began when voters elected L. Brooks Patterson, the former county prosecutor, as the new county executive in 1992. The county operates under a government structure that relies on leadership at the top: constituents elect a single county executive and a board of twenty-five county commissioners. When Patterson came into office, anxious about the county's ability to control future retirement expenses, he directed his staff to develop and present to the board a proposal to replace the county's current pension plan with a DC alternative.

Pension Reform, in Good Times and in Bad

Webster Groves, Missouri, also made a complete conversion to a DC plan. At the time of the shift, the city's traditional DB plan was running a substantial surplus. While this may seem an odd time to opt for pension reform, a surplus can actually create an incentive to convert to a DC plan: In a typical conversion, veteran workers often lose out; but a surplus can be used to fill in holes and ensure that workers receive benefits in the new plan equal to what they were getting in the old. This arrangement encourages existing workers to enroll in and support new DC plans. In the case of Webster Groves, employees voted overwhelmingly for the conversion, in part because the city planned a generous distribution of the DB surplus so that older and more veteran workers would not lose benefits in the conversion. The remaining surplus was used to fund additional insurance benefits.[5]

Patterson's proposal was favorably received by the board. "Everybody agreed. The board felt [the existing defined-benefit plan] was unsustainable," said board member Shelley Taubman. "There was great reluctance to raise taxes. We'd be asking folks for higher taxes to sustain an unsustainable benefit package." The board's eighteen Republicans and seven Democrats generally concurred that a simple adjustment of the DB plan would not suffice; instead, it would have to be completely overhauled. "We just knew it had to be done," said Taubman.[6] In June 1993, the DC proposal was approved 24–0 (one member was absent).

INTRODUCING A DC PLAN IN OAKLAND COUNTY

The county put in place a mandatory 401(a) DC plan—known as the Oakland Performance Retirement System—for all employees hired after July 1, 1994. Under the new plan, the county would pay 5 percent of wages into each employee's retirement plan. Employee contributions to the DC plan were barred, but the reform included a tax-deferred savings option to which new employees could contribute, allowing them to shelter income until retirement.[7] The plan would also allow workers who left before full vesting—six years of continuous service—to take some of the employer's contributions with them. During the vesting period, employer contributions would be placed in a secure default option—a conservative, balanced fund. Participants in the DC plan would direct the investments made by the county into their accounts. Initially, they could choose from a group of thirty alternatives, but investment options were later expanded to more than 1,300 mutual funds.[8]

Existing workers were given the option of remaining in the existing DB plan or transferring to the DC plan and receiving a credit for a retirement-fund balance equal to their benefits under the old plan. If they chose the new plan, the county paid 6 percent of their salaries into the new retirement plan, versus the 5 percent contribution for new workers. Existing employees who switched could also opt to make their own contributions to that plan, unlike new workers. If an employee chose to do so, the contribution had to equal 3 percent of that employee's salary, and would trigger an additional 3 percent match from the employer.[9]

When given the choice, most existing workers—like their counterparts examined elsewhere in this volume—decided to remain in the traditional DB plan. Still, 982 employees—over a third—switched to the new plan, versus 1,592 who stayed in the DB plan.[10] Several additional enrollment periods, plus six years of automatic enrollment of new hires, pushed total enrollment in the DC plan to more than 50 percent of all Oakland County employees by 2000.[11] Judy Fandale, the county's retirement administrator, credited the high rate (compared to, say, the U.S. government experience in Chapter I) to intensive employee education and a program allowing every employee to meet with a retirement counselor to compare benefits under the old and new plans.[12] By 2011, the DC participation rate had risen to a remarkable 80 percent of all county employees.[13]

Still, the county soon realized that its provisions for new hires—which excluded employee contributions—were less generous than those enjoyed by workers in the private sector and by previous hires. As interviews with county staff revealed, some departments were having difficulties recruiting new hires, particularly those specializing in information technology, because the new DC plan was not competitive with the plans of other employers.[14] So the county moved to improve the plan in 1999 and 2000, ultimately allowing new hires to contribute to their retirement accounts at a rate of 3 percent and matching 100 percent of that contribution, on top of the existing 5 percent employer contribution. The county also improved the DC plan for workers who chose to switch into it by raising the cap on employee contributions and their employer match to 5 percent each. In so doing, the county sought to encourage more senior employees to switch to the DC plan.[15]

AS INTERVIEWS WITH COUNTY STAFF REVEALED, SOME DEPARTMENTS WERE HAVING DIFFICULTIES RECRUITING NEW HIRES, PARTICULARLY THOSE SPECIALIZING IN INFORMATION TECHNOLOGY, BECAUSE THE NEW DC PLAN WAS NOT COMPETITIVE WITH THE PLANS OF OTHER EMPLOYERS.

Today, the DC plan is more advantageous than the traditional plan for some workers, but not for all. Actuarial comparisons indicate that younger workers who plan to leave county service are better off in the revamped DC plan than they would have been under the DB plan. For employees who expect to retire from the county, though, the DB plan remains superior. Pension experts Robert Clark and Fred Munzenmaier found substantial differences between the plans, depending on age and service. Financially, a fifty-year-old worker with twenty years of service does best in retirement by remaining in the DB plan until he is fifty-five and can retire with the full benefits at twenty-five years of service. If that worker chose instead to switch to the DC plan, he would see little buildup in that plan between ages fifty and fifty-five. Even the package the county offered to encourage the switch does not make up the difference for a worker nearing retirement.[16] Of course, the purpose of the pension overhaul was not to retain or increase benefits for employees, but rather to stabilize and reduce county costs. And while some individual employees might have objected to the switch, most did not, and the county faced little pushback throughout the process, as described below.

DRIVING A HARD BARGAIN

How was pension reform achieved in Oakland County? Throughout the process, county managers reached out to employee unions as well as department heads and the retirement system board of trustees, explaining exactly why the retirement-plan changes were needed.[17] Moreover, two factors specific to this county helped provide for its relatively smooth transition: First, Oakland County benefits from a decent working relationship with its unions, which cover about one-third of the county's workforce. As the county is moderately conservative, it maintains contracts with unions that, except for the sheriff's department, do not require the county to deduct union dues from paychecks. This arrangement is unusual among Michigan's public agencies. In practice, it cuts union income and pushes unions to bargain more carefully.[18] Second, Michigan allows public employers, in the event of a labor contract impasse, to institute a last, best offer. Before arriving at such an offer, of course, public employers have to meet a number of assurances (such as good-faith bargaining, nonbinding mediation, and fact finding), but the ability to impose management's last, best offer is key to enacting bold proposals. These combined elements can help prevent a prolonged, antagonistic negotiation process more typical of the labor-management framework.[19]

Six Lessons of Successful Retirement-Plan Change[20]

1. Start with a clear understanding of the financial picture, for both the short term and the long term.
2. Utilize actuaries, benefit consultants, and labor attorneys to glean best practices.
3. Provide financial facts to employees, labor groups, elected officials, board members, and other groups to ensure that all involved parties are sufficiently informed of the rationale for pension reform and the details of the new plan.
4. Outline the same provisions for union and nonunion employees.
5. Be credible and lead. Communicate facts to stakeholders, recognizing that facts might change in a fluid financial situation. If wages need to be cut, start with those of the leadership.
6. Do something: Even small, incremental changes yield big benefits over time. At a minimum, make changes going forward for new hires.

Oakland County used both of these elements to its advantage in pushing for pension reform. It first determined its budget and then based its proposal for employees on anticipated revenues and expenditures. It shaped a pay and benefit package for nonunion workers, and then introduced the same package in union negotiations. Because pay for union and nonunion workers must be competitive with that offered by the private sector, the county had to present a reasonable proposal from the outset—one that resembled its last, best offer. "Opening with one's best offer gives employees a more realistic sense of the employer's goals and reduces the risk that union officials will use the employer's initial offer to build resentment against management," according to Paul Kersey, of the Mackinac Center for Public Policy.[21] Opening with one's best offer also means that any calls for modifications must be adequately justified and supported. "The county is willing to make changes, but the union needs to be able to show the reasons behind its positions, and the reasoning has to be . . . persuasive to both elected officials and the public at large," says Kersey. Or, as Tom Eaton, the director of Oakland County Labor Relations, put it: "Give us a reason. We have people to convince."[22]

One element of the new pension-plan proposal that rendered it acceptable to unions was the provision that employees hired before July 1, 1994, could opt to remain in the existing DB plan, Fandale said. County Human Resources director Nancy Scarlet concurred: "We had to make changes . . . Either we were going to change [the plan] for active employees or for new hires. This was fair to new hires since they knew coming in what the county offered," she said. Moreover, introducing the plan would allow the county to meet its retirement obligations to existing workers, she observed.[23] (For a condensed list of pension-reform pointers from Scarlet, see the sidebar "Six Lessons of Successful Retirement-Plan Change.") The change also came as the DB plan was enjoying a good run on investments, which has helped keep it solvent despite having no new contributing members. Indeed, the plan has remained solvent with minimal county infusions, a rare case among other frozen DB plans. Since the switch, the county has needed to make additional infusions in only three years—1994, 1995, and 1996.[24]

ECONOMIC STABILITY IN TOUGH TIMES

The pension conversion saved Oakland County an estimated $85 million by 2010. (By comparison, county expenditures in that year totaled $716 million.[25]) In 2011, an editorial in the *Detroit News* urged that, as local public-employee labor contracts throughout the state come up for renewal, they should follow Oakland County's lead and switch to DC retirement plans. As the newspaper noted, "These savings have helped the county balance budgets. While many counties and municipalities and states are smashing on the fiscal rocks, Oakland County's latest three-year rolling budget is balanced for 2011, 2012, and 2013."[26]

THE PENSION CONVERSION HAD SAVED OAKLAND COUNTY AN ESTIMATED $85 MILLION BY 2010.

Patterson points out that the pension change also helped address the buildup of hefty legacy costs: "When I took over as Oakland County Executive in 1992, Oakland County was funding an expensive pension plan for its employees. Taxpayers paid into a retirement fund throughout a county employee's career, and continued to pay into that fund after the worker retired. This saddled the county budget with . . . legacy costs that could last decades more for each employee and his or her spouse." He estimated that the pension change now saves the county $7 million annually.[27]

Today, Oakland County fully funds its pension, health care, and other postemployment benefit obligations within its budget. (The county followed its pension-plan transition with the requirement that new employees contribute to a DC-style health care plan beginning in 1997; the same requirement was applied to all employees in 2003.[28]) And while Michigan has struggled with a decade of budget deficits, this county maintains cash reserves of well over 20 percent of general-fund expenditures.[29] Despite a still-fragile economic environment, Oakland County also is one of about three dozen counties in the United States that maintain the highest possible investment rating with Moody's and Standard and Poors, thanks in part to its ability to control retirement and medical legacy costs.[30]

The retirement-plan changes are only part of an aggressive countywide program to cut costs, to be sure. The county also reduced employee pay by 4 percent from 2008 to 2010, as it froze hiring.[31] Though such additional steps have prompted some tough union bargaining, the county has ultimately been successful in pushing for such measures. Deputy County Executive Robert Daddow said that the steps the county has gradually taken to realign employee compensation and benefits have played a significant role in allowing the county to weather fiscal problems that have affected the state and many local governments within Michigan.[32]

CONCLUSION

In order to mitigate the risk and uncertainty produced by its traditional pension plan, Oakland County engaged in commonsense planning and negotiations that resulted in a dramatic and money-saving switch to a DC plan. One key lesson is the importance of a point person—in this case, the new county executive, who pushed the plan, albeit to a willing, Republican-dominated commission. A leader who believes such a change is needed, as Patterson did, is pivotal to seeing the reform through to completion and ensuring that necessary information is collected ahead of time, plans are consistent and comprehensive, and stakeholders are adequately informed. Though Patterson could only indirectly control the process, he ensured that a sound and defensible proposal was crafted and presented to the board, that the board's questions were answered, that employees were well informed about the changes, and that the switch was methodically implemented. Recall that U.S. Senator Ted Stevens was the catalyst for the federal government's conversion outlined in Chapter I, and that President Gary Forsee pushed reform at the University of Missouri in Chapter V. While committees are surely a necessary element in introducing and shaping any government proposal, a plan can easily run aground without someone to keep it moving.

Also key to Oakland County's success was that the pension-reform proposal was largely understood to be a done deal upon its introduction. The county's experience is an important lesson in how a decent working relationship between local government and labor bargaining units can aid in the adoption of new and potentially touchy programs. Oakland County sets a budget first and then determines how much it can afford in wages and benefits; it then uses this information to craft a proposal based on fiscal realities. By opening negotiations with a realistic proposal, the county avoids low-balling and antagonizing its unions; at the same time, it insists that its union counterparts justify any proposed changes and base their suggestions on sound fiscal policy. Michigan law prohibits strikes by public workers, and this no doubt contributes to the unions' tendency not to engage in open discord. Still, the functional county-union relationship is also a result of an honest and straightforward negotiation process. When both sides approach a potential confrontation in a professional and direct manner, the result is more likely to be agreeable to both sides.

[1] L. Brooks Patterson, "Oakland County, Michigan County Executive Budget Message Fiscal Years 2011, 2012, and 2013 Triennial Operating and Capital Budgets," Oakland County Michigan, July 7, 2010, http://www.oakgov.com/exec/assets/docs/budget/070710_budget_message_FY2011-2013.pdf.

[2] Economic overview prepared by Robert Daddow, deputy county executive, for the Oakland County Budget Symposium, November 8, 2010, http://www.oakgov.com/exec/budgetsymposium/A_perfect_storm.pdf.

[3] Robert Clark and Fred W. Munzenmaier, "Impact of Replacing a Defined Benefit Pension with a Defined Contribution Plan or a Cash Balance Plan," *North American Actuarial Journal* 5, no. 1 (2001): 46, http://www.soa.org/library/journals/north-american-actuarial-journal/2001/january/naaj0101_3.pdf.

[4] Ibid.

[5] Joseph J. Jankowski, Jr., "Public-Sector Defined Contribution Plans: Lessons from Seven Governments," *Government Finance Review*, December 1, 1998, http://www.allbusiness.com/finance/733555-1.html.

[6] Author's interview with Oakland County commissioner Shelley Taubman, July 18, 2011.

[7] "Oakland County Michigan Comprehensive Annual Financial Report, Fiscal Year Ended September 30, 2009," Oakland County Department of Management and Budget, 109, http://www.michigan.gov/documents/treasury/630000OaklandCo20100325revised_326966_7.pdf.

[8] Jankowski, "Public-Sector Defined Contribution Plans."

[9] "Oakland County Michigan Comprehensive Annual Financial Report 2009," 109.

[10] Clark and Munzenmaier, "Impact of Replacing a Defined Benefit Pension," 46.

[11] Jankowski, "Public-Sector Defined Contribution Plans."

[12] Author's interview with Oakland County retirement administrator Judy Fandale, July 2011.

[13] L. Brooks Patterson, "2010 State of the County Address," February 3, 2010, 4, http://www.oakgov.com/exec/speeches/2010_soc/2010StateoftheCountyAddress.pdf.

[14] Clark and Munzenmaier, "Impact of Replacing a Defined Benefit Pension," 47.

[15] Ibid.

[16] Ibid., 48.

[17] Author's interview with Taubman.

[18] Paul Kersey and James M. Hohman, "Oakland County Gives Local Governments Something to Shoot For," Mackinac Center for Public Policy, August 9, 2011, http://www.mackinac.org/13343.

[19] Paul Kersey, "Coping with PERA: The Oakland County Model," Mackinac Center for Public Policy, February 14, 2011, http://www.mackinac.org/14598.

[20] These six lessons from Oakland County's experience were adapted from a more extensive list prepared by Nancy Scarlet, Oakland County Human Resources director. For more information, see Nancy Scarlet, "Savings from Benefits and Health Reform," presentation at the Oakland County Budget Symposium, December 7, 2009, http://www.oakgov.com/exec/budget/assets/Session4_Scarlet_Benefits_Health_Reform.pdf.

[21] Paul Kersey, "Coping with PERA."

[22] Ibid.

[23] Author's interview with Nancy Scarlet, director of Oakland County Human Resources, July 22, 2011.

[24] Author's interview with Fandale.

[25] "Oakland County Michigan Comprehensive Annual Financial Report, Fiscal Year Ended September 30, 2010," Oakland County Department of Management and Budget, 12, 181, http://www.oakgov.com/fiscal/info_pub/2010_cafr.html.

[26] Editorial, "Gov. Snyder's Plan Makes Reasonable Requests," *Detroit News*, March 22, 2011, http://detnews.com/article/20110322/OPINION01/103220311/Editorial--Gov.-Snyder%E2%80%99s-plan-makes-reasonable-requests.

[27] Patterson, "2010 State of the County Address," 3–4.

[28] L. Brooks Patterson, "Oakland County Fiscal Scorecard," Oakland County Michigan, February 2011, http://www.oakgov.com/mgtbud/info_pub/fiscal_scorecard.html.

[29] Ibid.

[30] "Wall Street Awards Oakland County Premier Short-Term Debt Ratings and Reaffirms Its AAA Bond Rating; Cites Medical Main Street," Oakland County, April 8, 2011, http://www.oakgov.com/about/news/2011/pr_11_41.html; and author's interview with Bill Mullen, Oakland County's media and communications officer, May 11, 2011.

[31] Susan J. Demas, "Toward a More Efficient Government," Center for Michigan, December 8, 2010, http://www.thecenterformichigan.net/toward-a-more-efficient-government.

[32] Ibid.

IV. When Big Blue Unplugged Its Big Pension Plan

On May 3, 1999, the International Business Machines Corporation (IBM) told its 141,000 American employees that the company would phase out its traditional defined-benefit (DB) pension plan in favor of a cash-balance plan aligned to the realities of the twenty-first century. The company and its workforce were both changing, and IBM believed that the old plan would no longer allow it to meet the needs of its employees and keep pace with new, growing, and aggressive competition. "For much of IBM's history, 30-year careers were the norm," Tom Bouchard, IBM's human resources chief, wrote in a memo to employees. "That career model is still viable for some, but it's no longer predominant," he explained, noting that 40 percent of the company's domestic employees had joined the firm within the last six years.[1] In addition to improving its competitive edge, IBM said the change was intended to save money and align employee benefits with those of its competitors.

THE COMPANY AND ITS WORKFORCE WERE BOTH CHANGING, AND IBM BELIEVED THAT THE OLD PLAN WOULD NO LONGER ALLOW IT TO MEET THE NEEDS OF ITS EMPLOYEES AND KEEP PACE WITH NEW, GROWING, AND AGGRESSIVE COMPETITION.

But IBM faced a rocky path to pension reform. The transition from a traditional DB plan to a cash-balance plan met with significant employee resistance. IBM had severely misjudged its workforce in regard to pension changes and failed to inform and prepare its workers adequately prior to the switch, resulting in a public-relations disaster and ultimately a legal battle.

Still, IBM learned from its mistakes. In 2006, the company announced that it would introduce an entirely new defined-contribution (DC) 401(k) plan. This time, the firm sought input from employees prior to the switch and did a better job of explaining why the change was necessary. The company also demonstrated that it was willing to revise its plan to accommodate employee needs, and to support employees during and after the switch. As a result, the new proposal met with significantly less resistance than had the cash-balance plan seven years earlier. IBM's experience demonstrates that pension reform is by no means a linear or effortless journey, but that proactive employers can take steps to preempt objections and promote employee buy-in.

IBM'S CHANGING COMPETITIVE LANDSCAPE

Historically, IBM made machines—first, standard mechanical office machinery and then computers and related hardware. In the early twentieth century, it competed for talent with other large, traditional American industrial firms, such as General Electric and Republic Steel. By the 1980s and 1990s, however, the revolution in personal computing introduced a different type of manufacturing and a new class of competition. The tide of the computer age carried IBM away from its traditional role of producing big mainframes and toward the unchartered terrain of computer software, data storage systems, and business consulting. IBM found itself trying to attract a different type of employee, competing for talent with the likes of new, tech-savvy firms such as Microsoft and Intel.

As the company sought savvier and more specialized employees, the size of its workforce shifted dramatically. IBM furloughed scores of workers and provided early retirement incentives for veteran workers. IBM's American workforce fell from about 225,000 employees in the 1980s to 95,000 by the 1990s, while the total number of retirees in the pension pool jumped from about 15,000 to about 100,000.[2]

As IBM sought a refreshed workforce and its retirement pool grew, the company observed that its new competitors typically offered pension plans that differed markedly from its own traditional plan (see the sidebar "The Rise of DC Plans"). Most offered DC plans with portable options and some immediate vesting, aimed at attracting fresh talent rather than retaining veteran workers. IBM recognized that, to attract the younger, tech-savvy workers that it sought, it would have to offer similar benefits at the outset of a worker's career. Explaining the benefit changes at a shareholders' meeting in Cleveland in 2000, IBM Chairman and CEO Louis V. Gerstner, Jr., summarized the company's thinking: "We must compete for talent and loyalty the same way our 'dot com' competitors do—more stock and cash up front and fewer 'old fashioned' benefits like pensions."[3]

IBM's traditional pension plan paid benefits for retirees based on 1.35 percent of average earnings over the most recent five years of work multiplied by total years of service. Historically, IBM allowed employees to retire under three scenarios: a worker with thirty years of service could retire at any age; at fifty-five, a worker could retire after at least fifteen years of service; and at sixty-two, a worker could retire with at least five years of service. In theory, a worker could graduate from college, work for IBM for thirty years, retire, and peddle the skills learned at the company into a second career. That worker

The Rise of DC Plans

While large corporations that shift away from DB plans make news, smaller companies led the way toward alternative plans. DC plans grew more popular in the private sector with the enactment of the Employee Retirement Income Security Act (ERISA) in 1974. ERISA (which applies only to the private sector) introduced minimum standards for pensions and regulated how those plans should function, creating incentives for employers to provide retirement-savings plans above a minimum funding level.[4] Subsequent federal tax changes made contributions to 401(k) plans tax deductible, resulting in a second boost in the proliferation of DC plans. Finally, the Pension Protection Act, which passed in 2006 and which amended ERISA, required that private companies fund pensions at 100 percent of their obligation, causing more employers to gravitate toward DC plans.

Many older, larger companies, especially those with unions, continue to operate DB plans. These firms are the ones that make news when they close their traditional plans to new employees and start something new. Recent examples include Boeing (2010), Wells Fargo (2009), Citigroup (2008), General Motors (2007), Lockheed Martin (2006), and Verizon (2006).

In 2010, according to an analysis by the benefits consulting firm Towers Watson, 38 percent of *Fortune* 1000 companies maintained DB plans (all of which remained open to new employees), compared with 59 percent in 2004. Turnover on that list reflects a broader shift away from DB plans for those companies with the most revenue: Firms falling off the list of *Fortune* 1000 companies usually have sponsored one or more DB plans in the past, while companies coming onto the list usually have not.[5]

could collect his IBM pension for as many years as he had worked at the company, perhaps longer.

IBM's old pension plan was *over*funded, thanks to the run-up in stock values during the 1990s. This was common for the pension plans of large corporations. In IBM's case, the pension fund was nearly $8.3 billion in surplus in 1998.[6] Accounting rules required companies to report a portion of such a surplus as extra earnings. Instead of using that surplus to boost employee benefits, many companies with overfunded plans chose instead to alter them, often resulting in less-generous future benefits for employees and even greater savings for the corporations.

WITH THE NEW PLAN, THE COMPANY AIMED TO PAD PROSPECTIVE EMPLOYEE BENEFITS BY REDIRECTING COSTS FROM DB PENSIONS TOWARD STOCK AND INCENTIVE-BASED REWARDS.

IBM spent much of the 1990s examining alternative pension plans and shaping a reform proposal before going public with any changes. The company took a few small steps toward reform before finally announcing in May 1999 that it intended to replace its traditional DB plan with a cash-balance plan for all new employees and most current employees.

With the new plan, the company aimed to pad prospective employee benefits by redirecting costs from DB pensions toward stock and incentive-based rewards. A cash-balance plan is a type of DB plan, but it differs from a traditional DB plan in that it allows pension benefits to accumulate steadily throughout a worker's career instead of slowly at the outset and more rapidly as the employee nears retirement. With a cash-balance plan, an employee can learn at any time how much is in his or her retirement account. And under IBM's version of the plan, employees could also leave the company and take their retirement-fund cash with them rather than wait for retirement. (They could also leave those monies in the fund to draw on when they reached retirement age.)

With a cash-balance plan, IBM hoped to attract workers interested in building capital during their early years of employment. It also hoped to encourage valuable employees not to retire early, as the new plan would offer lower benefits than the old plan at early and normal retirement ages. Originally, the idea was to allow about 30,000 workers within five years of retirement to choose whether to remain in the DB plan or switch to the new cash-balance plan; new employees and all other current employees would be moved to the new plan. The company would credit the value of pension benefits under the old plan to the new.[7]

Though the company described its motive as the desire to improve recruitment, and though it did plan to redirect some saved costs of the old plan toward new employee benefits, nobody failed to notice that—like many other large companies moving away from DB plans—IBM would save an estimated $200 million a year by adopting the plan, on top of its already-hefty surplus.[8] Still, the company sought to convince its employees that the switch was not financially driven: "It's important to know that we're not making this change to save money," the company told employees.[9] But with an extra $200 million a year padding its coffers, IBM perhaps underestimated its own ability to appear as a benign, altruistic employer.

REBELLION

IBM was used to getting things right. The company regularly conducted opinion surveys, employee meetings, and manager-worker talks to gauge employee attitudes on a wide range of topics. As a result, IBM executives felt that they had a solid understanding of employee concerns. They made a crucial mistake, however, by failing to conduct focus groups with workers to assess employee sentiment about pension reform in particular. The company ultimately found that it had completely misjudged the preferences and opinions of its veteran and mid-career employees regarding the switch. Many workers were outraged at being forced into a new retirement plan that, in their minds, amounted to a huge hit in benefits and added to the company's profit margin. IBM's efforts were met with angry employee protests, negative news stories, congressional hearings, an in-depth Internal Revenue Service investigation, and probing questions as to whether it was even legal to convert pension plans to cash balance.

The change was scheduled to take place on July 1, 1999, but employees around the country started protesting weeks before. When July rolled around, much of the action had shifted to Washington, where disgruntled IBM workers organized a July 1 rally and news conference. They asserted that the new plan breached age-discrimination laws, as it would leave older workers with fewer benefits than promised and less time than their younger counterparts to build up equivalent assets. "If they had told me twenty-three years ago, I'd have saved differently," said Janet Krueger, an IBM employee with two children in college and two more nearing college age. "People who could've retired at fifty-five will have to stay until sixty-five to get the same benefits," she said.[10]

The pension change quickly became a full-fledged political issue. Workers mounted a national campaign—writing letters, holding news conferences, and contacting their elected representatives—to argue that it was illegal to convert a traditional DB plan to a cash-balance plan. A Senate hearing commenced and "sunshine" legislation was introduced in the House of Representatives to address the notion that IBM had pulled the wool over its employees' eyes. "Employees have a right to know and understand the personal impact of any changes to their personal pension," said Rep. Jerry Weller, an Illinois Republican who had introduced a bill calling for employees to be informed of the effects of pension changes.[11]

Company workers also vented their displeasure in other ways. An Internet discussion group formed in the weeks before the change listed more than 5,000 messages. Some employees said the new plan would cut retirement benefits, including retiree health benefits, by as much as 50 percent.[12] In addition, workers at several plants began to organize in a group known as Alliance@IBM. Formed in August 1999, a month after the pension change took effect, the group provided a way for IBM workers to lobby Congress on pension and other labor issues and functioned as a clearinghouse for pension news. (Eventually, in 2001, it affiliated with the Communications Workers of America.)

This sort of rebellion was likely shocking to IBM, a stalwart of American industry that had prided itself over the years on good, if rather paternalistic, relations with employees.[13] By September, IBM backtracked, but only a little. It attempted to soften the blow by allowing additional current employees the option of remaining in the old plan, specifically those forty or over who had ten or more years with the company. That expanded the DB option to another 35,000 workers in addition to the 30,000 designated originally.[14]

But it was too little too late. IBM had become the target of a concerted campaign to roll back its pension change and, by November 1999, four months after the switch, the company found itself the defendant in a federal age-discrimination, class-action lawsuit filed by employee Kathi Cooper. The suit alleged that IBM's pension changes took away some benefits from older workers and gave them less time than their younger colleagues to build up new investments.[15]

Having already lost the public-relations battle, now IBM lost in court. In 2003, Judge G. Patrick Murphy of the Southern District of Illinois ruled that IBM had indeed discriminated against older workers forced into the cash-balance plan. He declared that the changes would leave them with smaller retirement benefits than younger workers would have when they eventually retired and that the cash-balance plan failed to treat workers equitably. The verdict caused shock waves—many businesses were in the midst of similar pension changes—and spread anxiety through corporate America.

IBM appealed the decision. "We stand by our plan and believe it does not discriminate on the basis of age," said an IBM spokeswoman at the time of the verdict. "Under the court's interpretation of the law, every cash-balance plan is illegal."[16]

TRY, TRY AGAIN

In an out-of-court settlement, IBM consented to pay more than $300 million, plus interest, to resolve a handful of smaller charges included in the lawsuit. But it held out on the lawsuit's two main age-discrimination claims: IBM agreed to pay $1.4 billion to Cooper and the other class-action plaintiffs concerning those issues, *but only if it lost on appeal.* It was a good bet. In 2006, a federal appeals court overruled Judge Murphy and held that cash-balance plans are not inherently age-discriminatory. In 2007, the U.S. Supreme Court declined to hear an appeal from Cooper and the other plaintiffs.[17] Thus the case was decided—in IBM's favor.[18]

But the company wasn't finished. In 2006, even before the Supreme Court declined to hear the appeal, IBM boldly announced that it would replace the cash-balance plan with a defined-contribution 401(k) plan for both existing workers and new employees. Executives again asserted that pension reform was critical to the corporation's long-term viability. Existing employees would retain any benefits earned through 2007, but after that point they would earn no additional funds under their previous plans.

On January 1, 2008, about 80,000 cash-balance participants, as well as about 30,000 employees still participating in the traditional plan, switched over to the new 401(k) plan. Under the new plan's terms, IBM paid automatic contributions of 1 to 4 percent of an employee's salary, depending on which pension plan had previously covered the employee. The company also matched optional employee contributions dollar for dollar up to 6 percent of salary. IBM's pension changes in the U.S. and abroad were projected to save the company up to $3 billion over five years.[19]

This time around, IBM handled potential resistance to the pension changes more deftly. CEO Samuel J. Palmisano convened top executives to figure out how to introduce IBM's 401(k) plan—a plan with more features and benefits than typical 401(k)s but markedly less expensive than IBM's old retirement plans. The company organized employee focus groups as well as many "town hall" meetings where executives explained the economics behind the decision and answered the question, "Why are you doing this?" Tom Midgley, president of Alliance@IBM, the group of IBM employees that fought the earlier cash-balance conversion, told *Bloomberg Businessweek* that there was less anger the second time around.[20] No doubt the court decision had taken considerable air from the resistance balloon.

WHILE IBM'S PATH TO ITS CURRENT 401(K) PLAN WAS BY NO MEANS STRAIGHT OR SMOOTH, THE COMPANY RECOGNIZED THE MISTAKES IT HAD MADE THE FIRST TIME AROUND AND WORKED TO CORRECT THOSE IN ITS SECOND ATTEMPT.

Still, the new plan had detractors. Lee Conrad, a union organizer and former IBM worker, told the *Washington Post,* "Employees are going to be losing out on all kinds of benefits. You've got to wonder what's going to happen to the next generation of workers."[21] In another interview, he questioned IBM's economic need: "Let's not forget that IBM is a profitable company . . . This is not a company that needs to do this. Maybe the executives should start feeling the pain that they're trying to pass off onto the employees. Maybe their retirement and perks should be cut."[22]

IBM, however, portrayed the transition as a win-win. "We're taking these actions to better control retirement-plan expenses, position the company for business growth and competitive strength, and preserve employees' earned retirement benefits, while instituting a leading-edge 401(k) plan that will be one of the richest in the country and a standard in the United States," said Randy MacDonald, IBM's senior vice president of human resources, as the DC plan change was announced. "We also believe these are prudent and balanced steps at a time of uncertainty and conflicting legislative and regulatory directions about defined-benefit retirement plans in the United States."[23]

In 2009, the IBM DC plan had more than 94 percent active participation and average account balances of $127,000, twice the national average.[24] Indeed, it is currently one of the largest 401(k) plans in the nation. It can leverage its size to get good deals on management fees that benefit employees. Also, to help employees who are averse to managing their retirement portfolios, IBM has created its own customized target-date investment funds with special mixes of securities and investments depending on how far an employee is from retirement. "IBM takes a very paternalistic and serious attitude in terms of the quality and the cost to participants," Ted Benna, who is often credited with designing the first 401(k) plan, told *Bloomberg Businessweek.*[25]

While IBM's path to its current 401(k) plan was by no means straight or smooth, the company recognized the mistakes it had made the first time around and worked to correct those in its second attempt. As a result, today IBM can claim generous pension offerings for its employees. Indeed, IBM's 401(k) is generally considered one of the best DC plans in the business—and the company has remained competitive with a younger, savvier workforce in its offices.

CONCLUSION

While changing a pension plan is clearly a business decision, it is much more than "just business" to those whose retirement income and future plans are affected by resulting disruptions. DC plans can save employers a lot of money, but can entail lower benefits for employees. So, while IBM's decision made economic sense for the company and allowed it to target a younger workforce, employee qualms were fully understandable.

If there is one thing that can be learned from IBM's eleven-year pension journey, it is this: Executives must give careful consideration to explaining the rationale for any reforms or changes in pension plans and must provide employees with the necessary supports to make the transition—recognizing that this alone may still not gain employee buy-in. A further lesson is that organizations in the process of pension transition have to be prepared to make adjustments when necessary. IBM reacted to the 1999 upheaval following its switch to a cash-balance plan by broadening the number of employees who could remain in the traditional plan. Later, when it switched from a cash-balance plan, it offered a generous DC plan in its place, one that *Bloomberg Businessweek* described as "sumptuous."[26] Then it addressed workers' anxiety about managing their investments by providing investment counselors and a benefits-assistance program to the tune of $10 million a year. As seen in this volume's final two chapters, the issues that educational institutions face when converting retirement plans are similar to those faced by IBM—determining how much the conversion will cost, whether it will work for employees, and whether it will entice good people to the organization.

In applying its pension reform to both new and existing employees, IBM invited significant pushback to the new plan from existing employees and their unions. As other case studies in this volume demonstrate, limiting pension reform to new hires only is one effective method of averting opposition to pension changes. In IBM's case, however, the decision to include existing employees was not simply a shortsighted political mistake: Big Blue wanted to encourage some workers to leave, and to do so, it had to eliminate incentives for existing employees to continue working until retirement. The pension reform accomplished this by removing the traditional stepladder structure of retirement and by introducing portability into the system. IBM understood that it needed to embrace the backlash from some of its employees in order to be more effective in the future.

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[1] "I.B.M. to Change Pension Benefits," *New York Times*, May 4, 1999, http://www.nytimes.com/1999/05/04/business/ibm-to-change-pension-benefits.html.

[2] Robert Clark and Fred W. Munzenmaier, "Impact of Replacing a Defined Benefit Pension with a Defined Contribution Plan or a Cash Balance Plan," *North American Actuarial Journal* 5, no. 1 (2001): 50, http://www.soa.org/library/journals/north-american-actuarial-journal/2001/january/naaj0101_3.pdf.

[3] Trish Nicholson, "Pension Revolt Catches Fire," AARP Bulletin, September 2000, http://www.globalaging.org/pension/us/private/pensionrevolt.htm.

[4] Costs can affect small companies more because they must spread additional expenses over a smaller cash flow and profit. A study by investigators at the Brookings Institution, Michigan State University, and Temple University found that meeting ERISA regulations was more costly for DB plans. A 1992 study published by the American Society of Actuaries and cited by the researchers indicated that of 1,084 DB-plan terminations, "government regulation" was most commonly listed as the top reason for the termination. Reasons for terminating a plan also varied by the size of the company: among terminated plans, 40 percent of plans covering fewer than twenty-five workers listed government regulation as the reason for terminating the plan, while 26 percent listed high cost, a reason not unrelated to government regulation. For firms with plans covering five hundred workers or more, government regulation ranked fourth (at 15 percent). William G. Gale, Leslie E. Papke, and Jack VanDerhei, *Understanding the Shift from Defined Benefit to Defined Contribution Plans* (Washington, D.C.: Brookings Institution, 1999), http://www.brookings.edu/es/events/erisa/99papers/erisa2.pdf.

[5] Brendan McFarland and Erika Kummernuss, "Pension Freezes Continue among *Fortune* 1000 Companies in 2010," Towers Watson, September 2010, http://www.towerswatson.com/united-states/newsletters/insider/2761.

[6] Ellen E. Schultz, "Overfunded Pension Plans Fatten Companies' Earnings," *Wall Street Journal*, June 15, 1999, http://cyber.law.harvard.edu/rfi/press/surplus.htm.

[7] Clark and Munzenmaier, "Impact of Replacing a Defined Benefit Pension," 51, 54.

[8] Ibid., 50.

[9] Schultz, "Overfunded Pension Plans."

[10] Darryl K. Taft and Edward F. Moltzen, "IBM Employees March against Pension Change," *CRN*, July 3, 1999, http://www.crn.com/news/channel-programs/18803847/ibm-employees-march-against-pension-change.htm?itc=refresh.

[11] Ibid.

[12] Ibid.

[13] For example, employees had access to group life insurance in 1934. In 1937, IBM was among the first major American companies to provide employees with paid vacations. In the 1950s, the company claimed there had been no layoffs since 1921, nor had it experienced any labor problems. In the 1970s, workers with twenty-five years of service were offered early retirement five years ahead of schedule. William Lazonick, "Evolution of the New Economy Business Model," *Business and Economic History On-Line* 3 (2005): 15–16, http://www.h-net.org/~business/bhcweb/publications/BEHonline/2005/lazonick.pdf.

[14] Clark and Munzenmaier, "Impact of Replacing a Defined Benefit Pension," 51.

[15] *Kiplinger's Personal Finance Magazine* interviewed several IBM employees during this time. Two of the employees were married to each other. The husband, Dave, a project manager, was fifty-two and had been with the company for thirty years; he was grandfathered into the traditional pension. His wife, Mary, a senior software engineer, was forty-three at the time. She had been with the company for twenty-one years and would have lost about half of her expected retirement benefit if IBM hadn't expanded the option to continue in the traditional plan. A third employee, Jeff, was a thirty-seven-year-old software salesman who had been with IBM for about fifteen years. Jeff had no concerns about the switch to the cash-balance plan. "I've more than met my financial goals to date and I have the freedom to take [my pension] with me," he said. Together, the experiences of these three employees confirm the view of many benefit experts that traditional pensions are better for older workers who plan to retire at a company, while cash-balance and DC plans are better for—or at least preferred by—younger workers. Mary Beth Franklin, "Balancing Act," *Kiplinger's Personal Finance Magazine*, December 1999.

[16] Mary Williams Walsh, "Judge Says I.B.M. Pension Shift Illegally Harmed Older Workers," *New York Times*, August 1, 2003, http://www.cwalocal4250.org/news/binarydata/ex%3D10604.pdf.

[17] Associated Press, "High Court Won't Hear Appeal in Suit vs. IBM," *San Diego Union-Tribune*, January 17, 2007, http://www.signonsandiego.com/uniontrib/20070117/news_1b17ibm.html; and "Supreme Court Declines to Review Cooper v. IBM and Appellate Court Rules That Cash Balance Plans Are Not Age-Discriminatory," Watson Wyatt Insider, February 2007, http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=16992.

[18] The ruling also greatly influenced the Pension Protection Act of 2006, which clarified that hybrid DB plans are not inherently age-discriminatory.

[19] Amy Feldman, "IBM Reinvents the 401(k)," *Bloomberg Businessweek,* July 2, 2009, http://www.businessweek.com/magazine/content/09_28/b4139058355275_page_2.htm.

[20] Ibid.

[21] Albert B. Crenshaw and Amy Joyce, "IBM Adds Its Name to List of Firms Freezing Pensions," *Washington Post*, January 6, 2006, http://www.washingtonpost.com/wp-dyn/content/article/2006/01/05/AR2006010502329.html.

[22] My-Ly Nguyen, "Workers' Reaction Mixed on IBM's Pension Change," *Press & Sun-Bulletin,* January 11, 2006, http://www.endicottalliance.org/Workers%27%20reactions%20mixed%20on%20IBM%27s%20pension%20change.htm.

[23] "IBM Changes U.S. Pension Plans, Effective in 2008, as Part of Ongoing Global Retirement Plan Strategy Shift," IBM, January 5, 2006, http://www-03.ibm.com/press/us/en/pressrelease/19090.wss.

[24] Feldman, "IBM Reinvents the 401(k)."

[25] Ibid.

[26] Ibid.

V. Reform Falters at the University of Missouri

State universities from coast to coast face serious fiscal challenges in their everyday operations. At a time when state funding is being reduced, big and small campuses alike struggle to attract and maintain money for research, student financial aid, building construction and renovation, and much more. As if these challenges weren't enough, state universities today face the huge challenge of supporting employee benefits such as medical care and pensions.

Academe's enormous public sector is not immune to the fiscal realities that have hit state and local governments over the last several years. While private universities have mostly utilized defined-contribution (DC) plans for decades—the largest and best known of these being TIAA-CREF—most state campuses are still wedded to defined-benefit (DB) plans that help comprise the trillion dollars in unfunded pension liabilities that now face their state governments. At the sprawling University of California system, for example, the challenge of paying for employee benefits is mind-boggling. By 2012, the ten campuses could be contributing as much as $700 million a year to keep their benefit plan afloat.[1] "People have just not faced the coming train wreck," said Daniel L. Simmons, vice chair of the California system's faculty senate, in 2010.[2]

While the University of California faces such dire straits due to a lack of foresight and poor planning, a few state systems have taken proactive measures to prevent the ballooning of pension liabilities. This chapter examines one such system: the University of Missouri. Though that system's traditional pension plan was relatively stable, administrators feared steep future costs in the wake of the economic downturn and determined to take preventive action. They developed a strategy to curb future costs by overhauling the university's longstanding DB plan and replacing it with a DC plan. In the end, however, even though the university solicited employee input and tried to explain the need for a new system for future workers, the proposal lost traction when confronted with concerns about the burden that this change might impose on low-income workers. The initial DC proposal eventually gave way to a hybrid DB/DC plan. Missouri's experience demonstrates the importance of taking proactive steps to keep an organization running in the black and having united leadership to shepherd pension reform though implementation—as well as ensuring that any changes are fair for all employees and clearly explained to them.

DARK CLOUDS LOOM ON THE FINANCIAL HORIZON

The University of Missouri's pension system was hit hard by the recession. In 2007, it reported an estimated net worth of almost $3 billion; by October 2010, this had fallen to $2.5 billion.[3] While the system remains in relatively good financial shape—in late 2010, it was still essentially fully funded—the recession served as a wake-up call for leaders of the four-campus system.[4] Worried about how market losses would affect future pension contributions, university administrators began to consider comprehensive reform.

The university's traditional primary retirement vehicle was a DB plan resembling those of many other public institutions: Faculty and staff can retire at fifty-five and receive 2.2 percent of their salaries for every year of employment, with benefits based on the average of their highest pay over five years. (This arrangement requires the university to calculate annually how much must be paid into the system to meet benefit commitments.) Vested workers who leave before retirement can take some of their benefit with them, depending on age and length of service.[5] The university has also maintained a supplemental, tax-deferred savings option to which employees can contribute, though with no employer match.[6]

Unlike most other state university pension systems, however, the traditional University of Missouri system requires the employer to pay *all* contributions to the DB plan. In a survey of fifteen peer universities conducted by the Missouri system, thirteen required employee pension contributions.[7] (This arrangement does not necessarily make Missouri more generous in terms of total compensation, however, as it has generally offered lower salaries than its peers and rivals.[8]) As a result of this finding, the Missouri system's board of curators (i.e., trustees) opted to introduce employee contributions as a first step toward altering its pension-system funding. In February 2009, the board voted to require all employees to begin contributing at the modest rate of 1 percent of up to $50,000 in annual earnings and 2 percent for amounts over $50,000.[9] In a memo to the university community, system president Gary Forsee wrote, "I know many of you are concerned about these changes, particularly the employee contribution to the pension plan. I appreciate your concern, but I believe you will understand the economic situation pressing upon us. We simply cannot afford for the university to take on the long-term liability required to keep the plan fully funded without your contribution."[10] The board made no guarantee that contribution rates would not continue to increase in the future.

Employee contributions began in July 2009 and met with mixed reactions. The university's Retirement, Health, and Other Benefits Advisory Committee discussed the reform with the university administration, voicing concern in particular about the burden it placed on low-income workers (one-quarter of whom earn less than $25,000 a year).[11] "I think the general feeling was that people in the lower-pay ranges would be [negatively] affected . . . and we asked that there be some mitigation of that," said Allen Hahn, chairman of the committee. But, he added, "It came down to a 'Thanks for your comments. Here's how it's going to be.'" Power plant maintenance worker Tim Aikern echoed the concern that the changes would be especially burdensome to the lowest-paid employees: "I feel they're strapping a burden on employees' backs, especially for low-income families," he said. "[It's] just another slice from your check, another avenue for them to take your money." Some faculty members questioned the extent to which pension reform would affect recruitment. Math professor Stephen Montgomery-Smith, co–vice president of the Missouri system's chapter of the American Association of University Professors, said the university-paid pension was something that attracted and kept employees despite relatively lower salaries. But Victoria Johnson, an associate professor of sociology, wasn't surprised. "The economy's in hard times," Johnson said. "We'll have to make sacrifices." [12]

ADMINISTRATORS CHAMPION A DC SOLUTION

Requiring employee contributions was just the first step, however, in overhauling the pension plan. While the university estimated that those contributions would boost the net worth of the retirement system to about $3.8 billion by 2019, officials still worried about paying for future benefits.[13] About 23 percent of employees were fifty-five or older, and the university feared that a stabilization fund set up to help cover fund losses would run out of money by 2015.[14] The university was stuck between revenue that had been essentially flat for years and increasing pension-plan costs. Officials were well aware that the actuarial assumptions that had guided estimates in the past could change in the future. Vice President for Human Resources Betsey Rodriguez advised the curators that they should not count on an 8 percent return on retirement fund investments. She also warned that the high turnover in employment that was a "significant funder" of the pension system (historically, half the university's staff left before the fifth year and 70 percent by the tenth year) might not continue.[15]

In light of these considerations, the curators and President Forsee, a former CEO of Sprint-Nextel, began to contemplate converting the whole system to a DC plan. The goal was to shift investment risk from employer to employee and, ultimately, to put the system on sounder financial footing by making the university's retirement expenses more regular and predictable.

The university studied pensions at fifteen other large state universities and discovered that only Missouri offered a pure DB plan.[16] Still, university officials knew that it would be a struggle to sell pension reform. With the fund in relatively good shape, they had plenty of time to make the case for reform—but the health of the fund worked against them, too, as it was a challenge to convince employees that reform was at all urgent. The administration began a public discussion surrounding the issue in early 2010. Officials made clear that any DC plan would apply only to new workers, although current DB plan members might have to pay higher contributions in the future. Forsee and Rodriguez met with employee groups throughout 2010. The administration also communicated with employees via the Internet, posting a pension presentation on YouTube and creating an online forum through which employees could make suggestions and leave comments relating to the pension change.[17]

THE GOAL WAS TO SHIFT INVESTMENT RISK FROM EMPLOYER TO EMPLOYEE AND, ULTIMATELY, TO PUT THE SYSTEM ON SOUNDER FINANCIAL FOOTING BY MAKING THE UNIVERSITY'S RETIREMENT EXPENSES MORE REGULAR AND PREDICTABLE.

Some employees were won over, but not all. Many members of the Retiree, Health, and Other Benefits Advisory Committee, including the chairman, Allen Hahn, were not convinced that this change was needed. "I think the common [view] is, well, everybody's doing a defined-contribution program, so we ought to do the same thing," he said. "And I think, in my opinion, we haven't really proven that case yet."[18]

Officials released a first draft of the DC plan in 2010. Incorporating faculty and staff input, it featured these elements:

- The university would pay 5 percent of an employee's salary into a personal account. Hourly workers would be required to contribute 1 percent and salaried employees 2 percent of their salaries.
- Employees could choose to make additional contributions up IRS limits. (In 2011, these limits were $16,500 for workers under fifty and $22,000 for workers age fifty and older.) The university would match any additional

contributions up to 2 percent of an employee's salary. Employees would vest in their personal contributions immediately and in the total amount after three years.

- The plan would cost Missouri about 8 percent of total payroll costs—slightly more than the university was paying for its current DB plan. The institutional cost would, however, become more predictable and the workers would bear the full risk of investment returns. "I would grant a slightly higher contribution by the university in exchange for some certainty in the long run," said Warren Erdman, a member of the board of curators.[19]

Again, however, concerns arose about the ability of low-income workers to pay into and carry the risks of a DC plan. Though President Forsee met with employees on all four campuses and tried to convince them that the proposed plan would minimize impact on them, he encountered apprehension. In November 2010, he named a systemwide advisory committee to study the issue.[20] In the face of grave concerns among faculty and staff, the curators postponed action on the plan from their December 2010 meeting to early 2011. Employees wanted a guarantee that the university would continue to fund in full the existing DB plan and that current employees would not lose any retirement benefits.[21] Prospects for a mandatory DC plan for new employees still seemed relatively good, but more study and discussion were needed to convince workers, especially those at the lower end of the pay scale.

THE DC PLAN STALLS

As the previous case studies suggest, organizational leadership is an important aspect of any successful pension-reform effort, particularly one that involves a complete overhaul of the system. Certainly leadership was important in Missouri's case. Forsee, who had been hired by the board in part to bring more business experience to the system president's office, was a strong voice championing a DC approach, and he roused Missouri's board of curators to push for reform. He resigned in early January 2011, however, to care for his ill wife. When he left, the plan might have faltered entirely, but the administration kept up its push in his absence. "The Interim President, taking his lead from the chair of the board of curators, picked up and carried on, saying, ''No change' is not an option,'" recalls Gary Ebersole, a faculty member at the University of Missouri at Kansas City.[22]

While the administration was resolved in its commitment to reform, it faced a less certain retirement-plan advisory committee. Two months after Forsee's exit, the committee concluded that the university should not continue to bear the financial risk for the current DB plan and that the best alternative was to replace it with a hybrid DB/DC plan. Committee members felt that shifting all the risk to employees was too much, especially for lower-paid workers, as they were already least likely to vest and, according to the advisory committee's report, would be least likely to take advantage of voluntary 401(k)-style retirement offerings.[23]

Still, the decision was a partial win for the administration, as the hybrid plan was a clear compromise on the advisory committee's part. "While most of the committee members would have preferred maintaining the current DB plan, that clearly was not in the cards," Ebersole said. "So the combo plan was a compromise wherein the market risk is shared by the university and employees."[24]

The advisory committee proposed an alternative draft plan with these features:

- For new workers (those hired after September 30, 2012), the plan would retain a DB component at a level of about half of the current DB plan. The university would contribute 3.4 percent of salary (compared with 7.25 percent for current workers), but new workers would not contribute to the DB plan.
- Employees would pay a mandatory 1 percent contribution to the DC portion of the plan. The university would contribute 2 percent of an employee's wages and would match 100 percent of an employee's contribution up to an additional 3 percent.
- The total university contribution to the proposed new plan would be projected to be between 7.5 percent and 7.9 percent, versus 7.25 percent under the existing plan.[25]

Instead of pushing for a pure DC plan, which would have shifted all risk to the employee and rendered employer contributions fully stable and predictable, the committee chose a more modest approach. (Still, since the plan would maintain a modified DB piece for new workers, the committee's recommendation seems to fly in the face of its own finding that the university should not bear the risk of a DB plan.) The hybrid plan took shape and gathered support rapidly and, in June 2011, the board of curators voted 7–2 to institute the committee's recommended plan for faculty and staff hired after September 30, 2012. Workers employed before that date would not be affected. Details, however, remain vague and the board will vote on the precise structure of the hybrid plan in late 2011.

Curators Don M. Downing and Wayne Goode were the only two curators who voted against the changes. "I don't think we have determined the viability of the existing [defined-benefit] plan, and I think we should do that first," Downing said. Goode worried that the hybrid would shift more risk to employees, who may not have the expertise to make wise investment decisions. However, board chairman Erdman said that extensive discussions among the administration, faculty, and staff over the last two years convinced him that future employees need to share the risk of pension investing with the university.[26]

CONCLUSION

In order to help curb unpredictable and rising pension costs, the University of Missouri took steps to shift risk away from the employer and to reduce and stabilize its institutional contributions. It initially began to require (modest) employee contributions, and eventually administrators introduced a radical proposal to replace the traditional DB plan with a DC plan for all new workers. The administration explained the need for change and solicited employee input through multiple means. The university's experience, however, shows that strong, committed leadership is vital to the adoption of a new plan. When President Forsee left, the curators continued to pursue pension alternatives, and though they encountered an advisory committee that might have preferred maintaining the current DB plan, they pushed the committee to reach a compromise. Still, the administration was not able to push through the less palatable DC plan it originally envisioned.

Concern over the impact of the proposed changes on low-income workers was a critical factor throughout the process. Though the hybrid proposal passed with a large majority, two of nine curators voted against it, largely because they were unwilling to place additional onus on the employee without stronger evidence that change was needed. If the university seeks additional pension changes in the future, it will need to address this issue head on, first demonstrating that change is indeed urgent, and second that a given change will not unfairly or overwhelmingly burden low-income workers.

The introduction of a pure DC plan would have further reduced Missouri's risk and costs in the long run. But the university's foray into pension reform demonstrates that instituting a hybrid plan is one way to move in the direction of a DC plan while rendering reform more acceptable to workers. Fiscal solvency is an employer's main concern in most any pension reform, but employees' anxiety cannot be ignored. As shown by Utah's experience in Chapter II, hybrid plans can also be implemented in innovative ways that do cap employer contributions, thus heeding employee concerns while addressing employer costs. Other employers moving toward pension reform should recognize that, even though a DC plan might be the obvious financial choice, other options are available that may prove to be the most viable in an atmosphere of fiscal anxiety and potential distrust.

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[1] Josh Keller, "As Pension Costs Rise, Public Colleges Pay the Price," *Chronicle of Higher Education*, August 29, 2010, http://chronicle.com/article/As-Pension-Costs-Rise-Public/124150. While the university's pension burden is huge, the state government's unfunded liability to state workers in 2010 was $500 billion.

[2] Ibid.

[3]Jacob Barker, "MU, City Consider Retirement System Overhauls," *Columbia Business Times*, November 12, 2010, http://www.columbiabusinesstimes.com/9645/2010/11/12/mu-city-consider-retirement-system-overhauls.

[4] "University of Missouri Retirement Program Update: Frequently Asked Questions," University of Missouri, October 26, 2010, https://uminfopoint.umsystem.edu/sites/hr/Benefits/DC_FAQs.pdf.

[5] Ibid.

[6] "Benefits Summary for Full-Time Faculty and Staff," University of Missouri, January 1, 2011, https://uminfopoint.umsystem.edu/sites/hr/Benefits/2011/2011_Benefit_Summary.pdf.

[7] "Benefits Package Update," *Spectrum*, April 2009, http://www.umsystem.edu/newscentral/spectrum/2009/02/19/benefits-package-update.

[8] Evan Bush, "Changes to UM System Pension Take Effect amid Mixed Reactions," *The Missourian*, July 5, 2009, http://www.columbiamissourian.com/stories/2009/07/05/um-system-pension-changes-take-effect.

[9] "Benefits Package Update," *Spectrum*.

[10] Ibid.

[11] Author's interview with Kelley Stuck, associate vice president of total compensation for the University of Missouri system, June 21, 2011.

[12] Bush, "Changes to UM System Pension."

[13] Barker, "MU, City Consider Retirement System Overhauls."

[14] "Meeting Minutes of the Retiree, Health, and Other Benefits Committee," MU Retirees Association, April 7, 2011, http://mura.missouri.edu/benefits-committee/0411.html.

[15] "Citing Confusion, Forsee Wants More Employee Input on Pension Changes," *Mizzou Weekly*, September 30, 2010, http://mizzouweekly.missouri.edu/archive/2010/32-6/citing-confusion,-forsee-wants-more-employee-input-on-pension-changes/index.php; and "Meeting Minutes of the Retiree, Health, and Other Benefits Committee," MU Retirees Association, December 6, 2010, http://mura.missouri.edu/benefits-committee/1210.html. Turnover can help fund a DB pension plan, as transitory employees often pay into the system but exit before they are vested and can take those monies with them, in effect subsidizing benefits for remaining workers.

[16] Betsy Rodriquez, "Peer Benefits Comparison: Faculty and Staff Feedback," presentation before the University of Missouri Compensation and Human Resources Committee, November 1, 2010, https://board.um.umsystem.edu/November%201%202010%20Compensation%20and%20HR%20Committee%20Meet/08%20INFO%204%20Peer%20data%20and%20feedback-BR-final.pptx.

[17] "Retirement Plan Project," University of Missouri, November 2010, http://www.umsystem.edu/ums/hr/benefits/retirementplanproject

[18] Barker, "MU, City Consider Retirement System Overhauls."

[19] "Retirement Plan Project," University of Missouri; and "Forsee Calls for Advisory Committee to Review Retirement Plan Options," *Mizzou Weekly*, November 4 2010, http://mizzouweekly.missouri.edu/archive/2010/32-11/forsee-calls-for-advisory-committee-to-review-retirement-plan-options/index.php.

[20] The systemwide committee appointed by Forsee, known as the Retirement Plan Advisory Committee, was independent of the Retirement, Health, and Other Benefits Committee, though one member from the latter did sit on the former.

[21] "Forsee Calls for Advisory Committee," *Mizzou Weekly*.

[22] E-mail from Gary Ebersole to author, September 9, 2011.

[23] "University of Missouri Retirement Plan: Report from UM Retirement Plan Advisory Committee," University of Missouri, March 2011, https://uminfopoint.umsystem.edu/media/hr/Retirement%20Plan%20Advisory%20Committee%20report.pdf.

[24] E-mail from Gary Ebersole to author, September 9, 2011.

[25] "University of Missouri Retirement Plan," University of Missouri.

[26] "Curators Approve Pay Raise, Changes to UM Retirement Plan," *Mizzou Weekly*, June 23, 2011, http://mizzouweekly.missouri.edu/archive/2011/32-32/curators-approve-pay-raise,-changes-to-um-retirement-plan/index.php.

VI. Four Charter Organizations Walk the Pension Tightrope

Charter schools, gifted with the freedom to operate outside of many ordinary requirements of state laws and regulations, were created in part to serve as testing grounds for alternative approaches to K–12 education. As charters have reimagined school structures, practices, and spending, one area that they cannot afford to ignore is the considerable cost of employee benefits. Yet this is one area where state restrictions often remain severe: Just sixteen of forty states with charter laws allow charter schools to opt out of their state retirement programs, plans which typically resemble traditional defined-benefit (DB) systems—and which therefore entail high and unpredictable employer costs.[1] But in the states that do allow flexibility, charter schools have chosen many different approaches to providing for employee retirement, sometimes joining their state plans, sometimes offering their own alternative plans, and sometimes offering no plans at all.

Each charter school or charter operator must weigh its own priorities, typically balancing a tight budget against the need to attract and keep top talent, in choosing or crafting a retirement plan. Few paths are alike. This chapter examines four charter organizations, each of which transitioned between pension plans because one or more of the initial plans were not meeting the schools' needs. Three of them are located in states that allow charters to opt out of the state system, and the fourth was the main impetus in leading its state to begin offering this option. In each case, different elements—fiscal realities, employee concerns, state laws, union presence, and more—bore on the eventual structure and shape of the resulting pension plan.[2]

LIGHTHOUSE ACADEMIES

Lighthouse Academies is a nonprofit, national charter management organization (CMO) that enrolls 4,600 students in fourteen schools across five states and the District of Columbia. Founded in 2003 by Michael Ronan, Lighthouse opened its first school in the Bronx in August 2004. Today, the organization employs 275 teachers, 198 support staff, and ninety-eight administrators.[3]

INSTEAD OF VYING FOR A LIMITED NUMBER OF VETERAN DISTRICT EMPLOYEES, LIGHTHOUSE RECRUITS YOUNG BUT TOP-FLIGHT TEACHING TALENT, SUCH AS THE BEST GRADUATES OF THE TEACH FOR AMERICA PROGRAM.

Many Lighthouse charters are located in depressed urban areas and enroll high proportions of poor students. For example, Lighthouse operates several schools around Gary, Indiana. The city lost 22 percent of its population over the last decade, and 33 percent of the population lived in poverty in 2009.[4] Cities such as this present unique challenges for school operators like Lighthouse, particularly when it comes to attracting and retaining classroom talent. Instead of vying for a limited number of veteran district employees—who would typically have much to lose in exiting district salary ladders and pension plans—Lighthouse recruits young but top-flight teaching talent, such as the best graduates of the Teach for America program. These young teachers often pause in places like Gary for a few demanding years, but eventually move on to attend graduate school, raise families, or embark on different careers. Recognizing this, Lighthouse knows that it must gear its retirement program toward mobility in order to attract these teachers in the first place.

Lighthouse instituted a defined-contribution (DC) plan for its staff when it began in 2004. It bases its benefit plans and professional development on the assumption that the average teacher will be employed for four to six years (average teaching experience before joining Lighthouse is three to four years), and matches employee retirement contributions up to 4 percent of salary. "We believed from the start that the total compensation package—benefits, salary, and professional development—needs to be tailored to attract teachers to challenging urban environments," said Ronan, who currently serves as Lighthouse president and CEO. "We need to have a system that is portable. Secondarily, we want to have our contribution structured so it encourages these young people to start saving for retirement." At the national office, 90 percent of the staff participates in the plan. School-site participation is growing and is expected to reach 65 percent by 2012.

But as a charter organization spanning multiple states, Lighthouse has not always been in a position to offer these benefits to all of its employees—a stumbling block that is reflected in its school-participation rate. Several Lighthouse schools are located in states that require all charter schools to participate in the state system. Only the Lighthouse schools in the District of Columbia, Indiana, and New York have the option of participating in Lighthouse's alternative plan.

Today, its Indiana schools comprise a significant part of the Lighthouse organization, and its Indiana employees represent much of the participation in its retirement system. But in 2005, when Lighthouse opened its first Indiana school, that state still required all charter-school employees to join its public retirement system. This presented two problems: First, it significantly increased the cost of operating schools in the state; Lighthouse was required to contribute 9 percent of an employee's salary, as opposed to up to 4 percent in its national plan. Second, it required employees to pay into a system from which they would most likely exit before their contributions were fully vested—exactly what Lighthouse sought to avoid in its own benefits program.

Considering the costs and shortcomings of the state plan, Lighthouse joined with others in the Indiana charter community to change the participation requirement. The process of changing the requirement was relatively simple: Lighthouse's authorizer, Ball State University, engaged state Senator Theresa Lubbers in a conversation about extending to charter schools the choice to opt out of the state retirement system. (Ball State and other public universities had recently succeeded in getting the law changed to allow their own organizations to opt out for certain employees.) The message to Senator Lubbers, and later to her colleagues in the statehouse, was clear: Opting out made sense for the universities because it helped them compete for better talent; charter schools faced the same challenges and should therefore enjoy the same option.

In 2007, Lubbers introduced legislation to extend the option to charter schools. That language was attached to an otherwise uncontroversial charter-school bill. Largely flying under the radar, it was approved by the Indiana legislature in a relatively speedy and smooth process. There was no resistance campaign, no rally, no marching, no sign-waving in front of the statehouse. The lack of pushback was perhaps aided by the fact that Lighthouse, as a small organization, generally operates outside of the limelight and purposely did not draw attention to the bill. Lighthouse chose instead to work through its allies in Ball State and the legislature to advance the measure. This approach sidestepped a potentially polarized debate between pro- and anti-charter organizations on the ground. "We may not like the politics of the day but we're not putting ourselves out there like other groups. We don't attract attention," said Ronan. "It wasn't like the charter community was raising a flag."

As soon as the bill passed, Lighthouse took steps to leave the state plan. Complete Compensation, an Indianapolis pension advisory service, was hired to help navigate the transition. Due to a discrepancy between the nonprofit status of Lighthouse's Indiana outfit and that of its national organization, its Indiana employees could not immediately be brought into the national retirement plan, which operates as a 401(k). To adjust the nonprofit status of the Indiana Lighthouse schools would require modifying their charters with Ball State, and Lighthouse knew that this process would require time. In order to exit the state retirement system as quickly as possible, Lighthouse temporarily transitioned its Indiana employees into a 403(b) plan—similar to the national 401(k) plan, but applicable to Lighthouse's Indiana nonprofit status. Once the schools' charters were amended, Lighthouse finally merged its Indiana employees into the national 401(k) plan.

Lighthouse kept its employees informed of the specifics of the transition through mailings and Web postings. In addition, a staffer from the pension-consulting company went to each school to explain the plan. Lighthouse did not, however, survey teachers to gauge their receptivity or to solicit input. "We didn't think the workforce would have a level of knowledge to contribute," Ronan said. As young employees for whom retirement is a distant concern, most workers had only a nuts-and-bolts interest in the new plan—they wanted to know how it worked and what benefits they would receive, rather than participate in the construction process.

Lighthouse has seen significant savings under the national plan; instead of contributing 9 percent of salary to the Indiana state retirement system, it now only has to match employee contributions up to 4 percent of salary. The difference has allowed individual schools to budget up to an additional $75,000 for teacher bonuses and incentives for student achievement. "We were using that money in a way more aligned with the notion of what people working in our schools valued," Ronan said.

Lighthouse would like to have the choice of opting out of state retirement systems wherever it opens new schools. Paying into the state system means cutting back elsewhere—which could make it much harder to attract and maintain the talent it needs. Lighthouse knows from experience that a portable retirement plan, flexible benefits, and compensation that rewards teachers for boosting student achievement are keys to the recruitment, development, and retention of highly effective teachers.

MID-MICHIGAN LEADERSHIP ACADEMY

Mid-Michigan Leadership Academy in Lansing is no stranger to adversity. Since the day it opened in 1995, the school has labored to escape a cycle of poor management, transitory leadership, and declining enrollment. Intimately entwined with these concerns—and sometimes at the root of them—have been serious financial difficulties. By 2004, Mid-Michigan faced the instability of having had seven leaders in five years; a student body that had shrunk from 1,300 students to just 250; and a management company that had recently been terminated due to misfiling of financial statements. The school's outlook was bleak, and its leadership recognized that, absent significant internal reform, it would have no choice but to close. To turn the school around, the first step was to get its finances in order.[5]

EMPLOYEE SALARIES AND BENEFITS REPRESENTED THE LION'S SHARE OF THE SCHOOL'S EXPENSES AND THAT . . . FISCAL BURDEN WOULD ONLY WORSEN IN THE FUTURE.

In June 2004, the school hired Mark Eitrem, a retired U.S. army officer, to lead the organization and address its financial situation. He understood that employee salaries and benefits represented the lion's share of the school's expenses and that the fiscal burden would only worsen in the future. Fortunately, Eitrem was in a position to negotiate new salaries and benefits with the school's employees: Though the school maintained a collective-bargaining agreement with its local union, it was an open-shop agreement, meaning that employees were not compelled to join. By 2004, only a handful of the school's forty workers were union members. Eitrem's first step was to negotiate with employees to limit salary raises to the rate of state-aid increases. He also decided that the school would not sign another union labor agreement when the present one expired.

Eitrem then addressed the school's participation in the state pension plan. Mid-Michigan had received notice in 2004 that its employer contribution under the Michigan Public School Employees Retirement System could potentially increase to over 30 percent of salary by 2020—and this estimate was probably optimistic because it was based on an unlikely expected return of over 8 percent of investments for the state plan.[6] The school was already paying a hefty 16 percent of employee salaries into the pension system. Even without an increase, Eitrem remarked, "In three years we would have been out of business."

Michigan law allows charter schools to opt out of the state system and also to utilize staff provided by third-party employers. Mid-Michigan did both. It made plans to remove itself from the state pension system and contracted with the Midwest Management Group, a Michigan personnel-services firm, to provide employees. Under the arrangement, the school would identify and select workers; those workers would then become employees of Midwest Management, which would in turn lease their services back to the school. All employees would be included in the arrangement, from administrators to teachers to support staff.

All employees would also be covered by Midwest Management's 401(k) DC plan. Under that plan, employees would guide their own retirement accounts. Personal contributions would vest immediately—as opposed to a ten-year vesting schedule under the state plan—and the plan would be portable. Employees could contribute to their accounts up to the Internal Revenue Service limits (currently $16,500 per year for workers under fifty and $22,000 for workers age fifty and older). In addition, Midwest Management would contribute 4 percent of salary to each worker's account, which it would then bill back to Mid-Michigan along with salary costs and other benefits. For its services, Midwest tacked on a management fee of 3.5 percent of each employee's salary.

Mid-Michigan kept employees up to date with all these changes via meetings, emails, and postings. In addition, a standing committee—comprised of two teachers, the school's social worker, a board member, and a student—joined with school leaders in the decision-making process. While individual concerns surfaced regarding medical benefits and related issues, employees were mainly worried about whether the school itself would remain open, whether everyone would still have jobs, and whether the budget-cutting and retirement-plan transition would be fair. Ultimately, employees did not push back against the reforms. "[The financial situation] was grim," said Eitrem. "I suppose they could have fought us but they also realized we had to cut everywhere."

The eighteen-month transition was concluded in June 2007. With so few remaining union members, the school's collective-bargaining agreement was not an obstacle, according to Eitrem. To work around it, Mid-Michigan first transferred all of the nonteaching staff out of the state plan and, when the collective-bargaining contract expired in 2007, it transferred the teachers, too. Eitrem believes that the transition from the state pension plan was smoother than it might have otherwise been because Mid-Michigan's workforce was generally younger and was not as invested in the plan as older workers might have been. "We had a number of teachers that were committed to the charter school and a number that were just happy to have jobs. And there were others that saw positive things happening at the school and they wanted to be part of something good," he said. Only one employee left as a result of the pension switch: the facility manager, who was looking to retire under the state pension system in ten years. The change also did not affect hiring. Mid-Michigan frequently receives around forty applications for each teaching opening, Eitrem reports.

The arrangement saved $80,000 the first year, annual savings that have continued to the present. Initially, Mid-Michigan used this "found money" to offer employee raises and hire an additional teacher. More recently, the school has directed its savings to defray health-benefit premium increases and to help purchase its property and buildings from the Michigan Department of Education.

But while the move placed Mid-Michigan on sounder financial footing and allowed the school to fund vital projects and benefits, the school's $2.5 million budget remains pinched, and Mid-Michigan continues to make sacrifices to avoid further slashing benefits or programs. Eitrem, who had planned to leave at the end of 2009, resigned six months early to help the school save money. His assistant principal replaced him, and that position was not filled. Though Eitrem's early departure was an unfortunate casualty of the budget situation, he sought to ensure that the school would keep its money problems as far from the students as possible. Eitrem said that it was either lose one of the administrators or lose a gym teacher, an art teacher, or both.

BAY HAVEN CHARTER ACADEMY

In 2008, when Florida's Bay Haven Charter Academy started losing teachers, founder and CEO Tim Kitts wondered why. As one of the Sunshine State's most academically successful charter-school networks, the academy had never before had problems attracting and keeping top instructors.[7]

Bay Haven is a system of five schools. It began in 2001 with 225 students in a single elementary school. By 2009, it had expanded into a middle school, with total enrollment topping a thousand students and hundreds more on a waiting list. Three additional schools—an elementary, a middle, and a high school—opened in 2010, pushing total enrollment today to over two thousand students. All these schools earn "A" grades from the Florida Department of Education.[8] They employ a total staff of 200, including 126 teachers.

But despite Bay Haven's strong academic track record, the academy lost fifteen employees in 2008. Salary, it seemed, was not to blame; employees generally considered the academy's pay level to be competitive with other charter and district schools. But benefits were a different story. "Many teachers said they wanted retirement security," according to Kitts. At the time, Bay Haven offered a DC plan. With the economic downturn of 2008, that plan lost much of its previous earning power; for the vast majority of employees—those without a defensively invested portfolio or simply dumb luck—returns fell far below their previous levels, and future earnings remained uncertain. Employees were straightforward about their anxiety. "They said, 'If you get the Florida retirement, we'll work for you,'" recalls Kitts.

Bay Haven took these concerns seriously and in 2010, while many charter schools were wishing they could exit from mandatory public retirement plans, the academy took steps to *join* the Florida Retirement System (FRS). The move was not without risks, however. State law provides that, once a school has joined FRS, the only way to exit the plan is to dissolve the corporation entirely and reorganize. Even more daunting, the academy had to trust that future costs of FRS would not outpace the school's financial projections. As employees made no contributions into the state retirement plan, the academy's contribution could potentially range from 7 percent to as much as 18 percent, based on the history of FSR employer contributions. Bay Haven officials weighed a number of variables and estimated that the school would have to pay 9 percent to 11 percent annually into the Florida system. If they were wrong, Kitts said, Bay Haven could be forced to freeze salaries, lay off employees, or cut drastically elsewhere.

The switch was a six-month-long process in which Bay Haven first applied to the state to change from being a private employer to a public employer and then applied to join FRS. In that time, Bay Haven also chose to alter its DC plan in order to continue it as a supplement to the FRS plan. Employees could continue to make contributions into it even though the academy itself would no longer do so. By December 2010, all changes had been finalized. In the 2010–11 school year, Bay Haven's first-year contribution to FRS was 11 percent—in line with the high end of its estimate. Joining the state pension plan cost the academy $650,000 that year, up from the $50,000 Bay Haven had been putting into its DC plan (though part of this increase was due to the addition of employees for the three new schools).

The academy's history of good fiscal health significantly contributed to its ability to fund the extra pension costs. In the five or six years before the switch, Kitts's tight fiscal management allowed him to save about $700,000 per year of the academy's $12 million annual budget, money which helped pay for capital improvements. Even after the switch, the academy has maintained $1.7 million in a reserve fund. "I have always tried to budget on 95 percent of the projected revenue base, not including the fundraising," said Kitts. "I actually work from the basic idea that if my budget is, say, $13 million, that I only have $12 million in my budget." In the future, Bay Haven will also benefit from 2011 legislation that requires employees to contribute 3 percent of salary to FRS—meaning that Bay Haven's contributions will be reduced by an equal amount.[9]

Still, joining the state retirement system had a significant impact on Bay Haven's budget. After the switch, Kitts had to make other adjustments, such as cutting back what had been an aggressive capital-improvements budget. But the academy's existing surplus helped soften the impact of redirecting funds toward the new pension plan; indeed, Bay Haven used the surplus money to continue with plans to purchase a new building and fund the start-up of three new schools, as well as to help pay for necessary renovations, office equipment, curriculum materials, classroom technology, and salaries.

As the switch to FRS arose from employee concerns, Bay Haven faced little employee pushback. Still, the school strove to be transparent and to explain the decision-making process throughout, especially in the absence of a union to channel employee concerns. Bay Haven brought in retirement professionals to explain the process and its long-term benefits. "We created a 'pros and cons' list and showed the employees all the advantages and disadvantages associated with the change. The majority sincerely bought in and they carried the day on moving in this direction," Kitts said. "They have no qualms about it, since they have great jobs and are paid well," he said.

With the state plan in place, Bay Haven saw higher staff retention in 2011 and was able to attract top teaching talent—with more than fifty individuals being hired in that one year. The academy's three-pronged retirement system—FRS, a DC plan for employee contributions, and Social Security—is now more generous than what employees receive in district schools, which offer only FRS and Social Security. In addition, teachers from district schools no longer need to worry about losing their public pensions in moving to a charter school. "People left the [local public school] district to come to us," according to Kitts. "Some of these teachers are real veterans and they're still performing at a very high level."

SOMETIMES THE CHOICE OF THE RIGHT RETIREMENT PLAN FOR A SCHOOL CAN BE A TRIAL-AND-ERROR PROCESS.

Going forward, however, Kitts is mindful that risk as well as reward is associated with the move. Like other states, Florida is currently suffering a budget crisis, and state aid to education could be slashed. A reduction of 10 percent, for example, would be tough on school budgets, but Bay Haven is dedicated to its new pension plan even if it leads to layoffs, Kitts said.

LAFAYETTE ACADEMY

As the experiences of Lighthouse Academies, Mid-Michigan Leadership Academy, and Bay Haven Charter Academy have shown, the selection and operation of a state or private retirement plan for a charter school are not always straightforward processes. State requirements, the interests of teachers (both new and veteran), and the school's financial realities are all critical considerations when instituting or altering a retirement plan. Because there are always conflicting interests, sometimes the choice of the right retirement plan for a school can be a trial-and-error process. Such was the case with Lafayette Academy, a New Orleans charter school serving students in kindergarten through seventh grade.[10]

A converted district school, Lafayette opened in 2006 in the wake of Hurricane Katrina. Nearly all of Lafayette's student body (98 percent) qualifies for free or reduced-price lunch. The vast majority of its students are black. The school is overseen by the Choice Foundation, a nonprofit organization founded in 2004 to promote school choice in Louisiana.

Louisiana is one of the handful of states that allows charter schools to opt out of the state retirement plan. When the Choice Foundation was awarded the charter for Lafayette, it contracted with a for-profit management company to operate the school. Together, the management company and Choice decided to exit the state plan, in which the school had been enrolled as a district school, and instead to establish a 401(k) DC plan for Lafayette employees. Unfortunately, the management company soon ran into trouble, and in July 2007, after just one year, the Choice Foundation terminated its contract to operate Lafayette for multiple causes and failings. (Later that year Choice would go on to win a judgment of $350,000 from the company for unearned profits.[11])

The management company's exit created an unstable situation. Indeed, Choice Foundation chairman James Huger described the state of affairs at Lafayette as "chaotic." Staff turnover, combined with the lack of a curriculum to match state testing expectations and resulting poor academic performance of students, fueled employee dissatisfaction. Many of the teachers hired when Lafayette first opened had previously been district teachers, and many of them now threatened to leave Lafayette and return to the school district. One reason that they cited was a desire to re-enroll in their previous plan, Teachers' Retirement System of Louisiana (TRSL). "[Teachers] were unhappy because the environment was chaotic. The retirement issue was probably not key, but certainly added to their woes," Huger said.

In order to reduce turnover and address the concerns of veteran teachers, Lafayette took steps to rejoin TRSL, which welcomed the school with open arms—no surprise, considering that the state system was more than $9 billion in the hole in 2009 and could use any and all additional funds. (Some estimates, using a lower, more realistic rate of return, place TRSL's total unfunded liability as high as $17.5 billion.)[12]

Unfortunately for Lafayette, it rejoined the system just as contribution rates spiked. Employer contributions jumped from 15.5 percent in 2009–10 to 23.7 percent in 2011–12. (Teachers also pay 8 percent into the state plan at current rates.) Nearly 18 percent of the 2010–11 amount was used to address TRSL's unfunded liability. Combined with state cuts to education, the expense was unsustainable.

As a result, just two years after joining TRSL, Lafayette made the decision to pull out of it once again. TRSL attempted to block Lafayette from leaving, but Lafayette appealed to the Louisiana Board of Elementary and Secondary Education. The appeal became moot, however, when the school's charter expired, allowing Lafayette the chance to put in place a new charter that removed the school from the state system and established a DC plan.

Under that new plan, Lafayette pays a base contribution of 3 percent of salary into each employee's retirement account. It also offers a match of up to 2 percent of salary for all employee contributions. Employees may contribute up to the legal IRS maximum, but Lafayette's contributions are capped at 5 percent of salary.

Given the drastic reduction in contributions, it was clear to all involved parties that the new plan was not as generous as the state plan. "The TRSL is a defined-benefit plan which is much more expensive and therefore much more beneficial to employees upon retirement," said James Fulton, business manager of the Choice Foundation. In order to minimize negative employee reaction to the switch, Lafayette has held several meetings with teachers, support staff, and administrators to outline the untenable costs of TRSL and the need for a less expensive plan. Several employees understandably expressed concerns about the transition from TRSL to the DC plan. Perhaps because of the organization's transparency, however, Fulton reports that Lafayette has not yet had anyone leave because of the change.[13]

Lafayette was not the first charter school to exit Louisiana's retirement system (though it may be the only one to enter and then exit in such a brief time): The KIPP schools in New Orleans received special permission from the Louisiana education department to leave TRSL in 2010. While finding the right retirement plan for Lafayette was tricky, the Choice Foundation had greater success with its second school, Esperanza Academy. When the Choice Foundation took over Esperanza in 2008, the school was not enrolled in the state system. Choice decided to keep it that way. Because the school's teachers are typically younger and less experienced than those at Lafayette, without yearnings to rejoin a pension system in which they had once participated, a portable DC plan works well at Esperanza.

For Lafayette, however, Huger describes the school's exit from TRSL as a catch-22: The school could best attract experienced teachers with TRSL, but the high costs associated with participating in TRSL meant that it couldn't afford to hire those very teachers. By exiting the TRSL, Lafayette did what it needed to in order to stay in operation; in the end, the effects of that choice on its talent pool and academic performance are a gamble that the school had to take.

CONCLUSION

While the four charter organizations described here faced different obstacles and considerations in reforming their retirement systems, in every case the decision was framed around a balance between budgetary restrictions and human resources objectives. For Bay Haven, the added cost of the state pension plan was a price worth paying to retain a strong talent pool. For Lighthouse and Mid-Michigan, a DC plan helped the charters both save money and attract top young talent. For Lafayette, dismal financial circumstances cast a dark shadow on the school's attempt to appease its employees, and the school ultimately sacrificed the desires of its veteran workforce in order to stay solvent.

Staying solvent (or profitable) is the primary reason that organizations and businesses switch from DB to DC retirement plans. Even in tight budgetary times, however, parsimony cannot be an organization's sole concern, as Bay Haven demonstrated in making the reverse switch. While many politicians call for making public retirement systems more like those of the private sector, at some point every organization, public or private, must attract and retain competent help. From that perspective, a retirement plan is simply another way to compensate workers.

Schools contemplating pension transitions obviously need to understand the likely budgetary and staffing impacts of any changes. Gauging current employees' receptivity and keeping them apprised of developments throughout the transition process are vital. Mid-Michigan made clear to its employees the school's dire fiscal situation and, while employees could have pushed back, they largely didn't. Of course, Mid-Michigan and the other schools profiled here generally employ teachers without union representation; charters operating under collective-bargaining agreements may need to be more creative—or adamant—in gaining employee buy-in and negotiating new benefits.

RATHER THAN SIMPLY SAVE MONEY, THE CHARTERS PROFILED HERE REINVESTED THEIR SAVINGS IN ADDITIONAL PROGRAMMING, SCHOOL IMPROVEMENTS, AND MORE ATTRACTIVE SALARIES.

Charter schools should also recognize the varied options available to them, even in states that currently mandate participation in the state plan. Though Lighthouse operated in a state that initially gave charters no freedom to leave the state retirement system, the school worked through legislative and political channels to effect changes in those rules rather than accept the status quo. Mid-Michigan hired a third-party vendor to handle its personnel costs, rather than set up its own retirement plan. Lafayette simply waited for its charter to expire in order to exit the state retirement plan. None of these charters was content with business as usual, and each found a unique avenue through which to achieve its desired transformation.

Perhaps most importantly, throughout the pension-reform process, the charters profiled here stressed providing improved services for their students and teachers. Rather than simply save money, they reinvested their savings in additional programming, school improvements, and more attractive salaries. Lighthouse introduced teacher bonuses and performance incentives after instituting its DC plan in Indiana. Even Bay Haven, whose costs increased substantially when it switched to the state system, ensured that it could still support three new schools and purchase a new building, in addition to providing additional curricula and improving technology.

Still, none of these plans is perfect. As costs, even under DC plans, continue to rise, these charter schools' retirement plans may require further alterations. But for charter schools looking to take a first step in transforming their pension plans, they show that charter autonomy should not only apply in the classroom, but also extend to the very structure of school operations. Only with the capacity to attract and retain the best talent available can charter executives lead their schools to success.

[1] Amanda Olberg and Michael J. Podgursky, *Charting a New Course to Retirement: How Charter Schools Handle Teacher Pensions* (Washington, D.C.: Thomas B. Fordham Institute, 2011), http://www.edexcellence.net/publications-issues/publications/charting-a-new-course-to.html.

[2] Except where noted, the information provided in this chapter originated from interviews with school personnel.

[3] Information on Lighthouse Academies was provided by Michael Ronan, Lighthouse's president and chief executive officer, in interviews with the author throughout 2011.

[4] U.S. Census Bureau, "Profile of General Population and Housing Characteristics: 2010; Gary, Indiana," American FactFinder, http://factfinder2.census.gov/faces/nav/jsf/pages/searchresults.xhtml?refresh=t; and U.S. Census Bureau, "Gary, Indiana Fact Sheet," 2005–2009 American Community Survey, http://factfinder.census.gov/servlet/ACSSAFFFacts?_submenuId=factsheet_0&_sse=on.

[5] Information on Mid-Michigan Leadership Academy was provided by Mark Eitrem, Mid-Michigan's former principal, in interviews with the author throughout 2011.

[6] Citizens' Research Council of Michigan, *Financing Michigan Retired Teacher Pension and Health Care Benefits* (Livonia, MI: Citizens Research Council of Michigan, 2004), 4, 8, http://www.msbo.org/services/biz/2006/FinMIRetiredTeacherPension.pdf.

[7] Information on Bay Haven Charter Academy was provided by Tim Kitts, Bay Haven's founder and chief executive officer, in interviews with the author throughout 2011.

[8] Rather, all the schools that have been graded have received a grade of "A"; the high school had not yet received a grade at the time of publication.

[9] E-mail from Edgar Ramsey, Bay Haven's chief financial officer, to author, August 15, 2011.

[10] Information on Lafayette Academy was provided by James Huger, chairman of the Choice Foundation, in interviews with the author throughout 2011.

[11] Darran Simon, "Charter School Wins Lawsuit against Management Company," *Times-Picayune*, September 14, 2007, http://blog.nola.com/times-picayune/2007/09/charter_school_wins_lawsuit_ag.html.

[12] Stuart Buck, *The Teachers Retirement System of Louisiana: Unsuitable for Charter School Teachers* (New Orleans, LA: Pelican Institute for Public Policy, 2011), http://www.pelicaninstitute.org/wp-content/uploads/2011/06/TRSL_Final.pdf.

[13] E-mail from James Fulton, the Choice Foundation's business manager, to author, August 18, 2011.

Conclusion

WITH CHESTER E. FINN, JR.,
JANIE SCULL, AND
AMBER M. WINKLER

What do these cases teach us? Three overarching lessons.

First, this is messy, complicated work, fraught with challenges. Yet smart organizations *can* prepare for them. The organizations that enacted the most dramatic and efficient pension reforms were those that moved proactively, prepared their employees for the shift, and mustered hard data to document their assertion that the status quo had become unsustainable and change was therefore unavoidable. In almost every case we examined, the greatest challenge in enacting pension reform was to convince current employees that change was necessary and that it would not be detrimental for them. Those organizations that managed the smoothest transitions gauged employee sentiment at the outset and informed employees of new developments and potential outcomes well before any change took place. They also effectively demonstrated to their employees that inaction would lead to even more dire consequences—at best, layoffs and other budget cuts, and at worst, the dissolution of the organization.

Second, cost savings from pension reform may be real but not immediate. One of the strongest criticisms that opponents can hurl at pension reformers is that changing plans may actually cost more in the near term. That's because, without new employees to subsidize lingering DB plans, the employer is suddenly on the hook for more costs going to support today's DB retirees and any current employees who remain in the DB plan. One way to ease those costs is to shut down the DB plan entirely and include existing as well as new employees in the new plan. But as several cases in this volume show, the stormy political climate surrounding reform—even in private institutions—does not often tolerate such sweeping moves (and placing employees, especially those near retirement, into a new DC plan may not be fair). In any pension switch, the ability to show how pension reform can save thousands, millions, or even billions of dollars *down the road* is pivotal. This is true not only before the reform takes place but in the years after; in many of the cases we examined, opponents to the reforms remain vocal to this day, well after the new plans have gone into effect.

Third, employers need not choose between saving money and disregarding employee concerns. Though most organizations examined in this volume adopted new retirement plans in order to save money, many took pains to minimize real or perceived harm to their employees. That doesn't mean avoiding all pain—a key goal of pension reform is to shift some investment risk and expense from employer to employee, and most every transition documented within these pages did so—but employers can take actions to keep that discomfort within reasonable bounds. Some organizations reinvested savings elsewhere—e.g., one charter school raised teacher salaries and bonuses, while another employer used savings to hire investment counselors for its employees. Others found ways to overlay different plan components into a blended retirement system so that employees would benefit from a menu of options and be somewhat protected from investment risk. Utah, for instance, instituted an innovative hybrid plan that offers employees DB-style protection while capping state contributions. At the end of the day, saving money in and of itself is not the ultimate aim of any reform; rather, saving money is a means to stabilizing an organization and making it stronger, healthier, and more productive—all of which is good for the organization's present and future employees, too.

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Glossary[1]

Cash-balance plan–A type of defined-benefit plan that defines the promised benefit in terms of a stated account balance. Each year, a worker's account is credited (using a formula) with a pay credit (such as 5 percent of compensation) and an interest credit (either a fixed rate or a variable rate that is linked to an index such as the one-year Treasury bill rate). Increases and decreases in the value of the plan's investments do not directly affect the benefit amounts promised so the employer still guarantees the eventual retirement benefit. A cash-balance plan defines the benefit in terms of an account balance in contrast to a defined-benefit plan which defines the benefit in terms of a monthly payment.

Defined-benefit plan–A pension plan in which an employer promises a specified monthly lifetime benefit when a worker retires. It is typically based on a formula including wages, length of employment, and age.

Deferred-compensation plan–A retirement plan that allows employees to defer income taxation on retirement savings into future years. A common example is the 457(b) plan, which applies to employees of certain state and local governments and tax-exempt organizations.

Defined-contribution plan–A retirement plan to which the employer and employee can make specified contributions, although those contribution levels can change. Contributions are made before tax and accounts accumulate tax-deferred. In some cases, the employer limits the annual amount that an employee can contribute, but no employee may contribute above IRS limits, which in 2011 were $16,500 for workers age forty-nine and younger, and $22,000 for those age fifty and older. At retirement, the employee has an amount of cash in his or her account. Different types of defined-contribution plans apply to employees of different organizations, but all operate in the same manner. For example, 401(k) plans are for both public and private workers; 403(b) plans are for employees of certain not-for-profit organizations and for public-school employees.

ERISA–The Employee Retirement Income Security Act of 1974 is a federal law that sets minimum standards for pension plans in private industry. The law sets minimum standards for participation, vesting, benefit accrual, and funding and defines the length of time that an employee is required to work before becoming eligible to participate in a plan and to accumulate benefits.

Tax-deferred savings program–A supplementary retirement savings plan that allows workers to make voluntary salary deferrals to reduce their taxable income through payroll deduction for investment in stocks, bonds, mutual funds, and other investments. The term "tax-deferred savings program" can be used as an umbrella term for defined-contribution plans; but typically, tax-deferred savings programs operate as add-ons to other primary retirement plans—they do not oblige any employer contribution, and employee contributions are completely voluntary—while the term "defined-contribution plan" typically refers to an employer's primary retirement vehicle.

Thrift Savings Plan (TSP)–A defined-contribution program that allows federal employees and members of the armed forces to make tax-deferred contributions similar to those for 401(k) plans. For employees covered under the Federal Employees Retirement System, employing agencies also make contributions.

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[1] Definitions were derived from the U.S. Department of Labor, Internal Revenue Service, and Federal Retirement Thrift Investment Board. For related terms, see "Glossary of Compensation Terms," Bureau of Labor Statistics, U.S. Department of Labor, http://stats.bls.gov/ncs/ocs/sp/ncbl0062.pdf; and "Frequently Asked Questions," Employee Benefits Security Administration, U.S. Department of Labor, http://www.dol.gov/ebsa/faqs/main.html.

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