Pension reforms lead to changes in worker behavior

November 14, 2017

MarketWatch Blog by Alicia H. Munnell

Alicia H. Munnell is a columnist for ***MarketWatch*** and director of the Center for Retirement Research at Boston College.

These responses need to be factored into reform packages

Those of us who think about state and local retirement plans tend to focus on funded levels, the implications of large liabilities for borrowing costs, and the extent to which required contributions may crowd out other activities in the state's or locality's budget. We tend to lose sight of the human resources (HR) aspects of public plans. Namely, they are part of a compensation package designed to attract talented people to teach our children, protect our lives and property, and run the government's operations.

Recently, two items – one from Dallas and one from Rhode Island – reminded me that it's important to pay attention to the HR implications of proposed pension reforms. That is, the response of individual participants to changes in their pension plan can introduce unforeseen wrinkles and additional costs into pension reform efforts.

Earlier blog posts covered **the situation in Dallas**, but here's a brief recap. At the end of 2016, the Dallas Police & Fire pension plan was estimated to be about 35 percent funded. At the same time, Dallas had a very large and generous Deferred Retirement Option Program (DROP). The DROP balances accounted for 56 percent of plan assets, meaning that more than half of plan assets were available for immediate withdrawal, which seriously exacerbated the plan's financial problems. In May of 2017, the Governor of Texas signed a pension reform bill that reduced benefits, reformed the DROP program, and raised revenues.

Apparently either in anticipation of or in response to these proposed changes, 460 officers left the Dallas police force during fiscal year 2017. The city offset some of this loss with an aggressive hiring initiative, but the new hires need nine months at the police academy and seven months of field training before they hit active duty. In other words, Dallas is short-handed. To meet this shortage, Dallas is rehiring retired officers as civilians to free up current officers to return to the streets. The ex-officers will work 30-hour weeks and be eligible for city health insurance subsidies but will not accrue sick or vacation time or retirement benefits. The overall impact on the government's finances may not be significant, but the disruption in services certainly was.

In the case of Rhode Island, in November 2011 the General Assembly passed, by an overwhelming majority, legislation that moved the state-administered pension system toward a firm financial footing. The reforms suspended the cost-of-living adjustment on retiree benefits until the funded levels reach 80 percent, raised the retirement age, and replaced the existing defined benefit plan with a hybrid. The legislation cut the plan's unfunded liability significantly and reduced state expenses over the next 25 years. The legislation was challenged in court, but eventually went into effect in 2014.

Not surprisingly, in the wake of these cutbacks, public employees have begun staying in their jobs longer. This response created an older and therefore more expensive workforce.   Higher personnel costs exacerbated the pressure on Rhode Island's already-strained budget. To relieve the budget pressure, the governor has proposed to offer one-time retirement incentives – up to $40,000 – to 940 workers. By hiring younger – and cheaper – workers to fill some of the slots and by letting some of the slots go unfilled, the state will cut its costs.

The point here is not to criticize the reforms in either Dallas or Rhode Island. In both cases, they were bold efforts to solve serious financial challenges, they got all the relevant players around the table, and they spread the pain across workers, retirees, and taxpayers. Rather, the point is that big changes in compensation packages can have significant changes in worker behavior and those responses should be factored into the analysis.