

EDUCATION WEEK

Published Online: April 19, 2011

Published in Print: April 20, 2011, as **Teacher Pension Reform: Make Systems Transparent**

COMMENTARY

Educator Pension Systems Ripe for Reform

By **Robert M. Costrell** and **Michael Podgursky**

The state of educator pension systems in many states is troubled, as anyone who has read the headlines about funding shortfalls must know. Clearly, it's time for significant change, but in making changes, policymakers must carefully consider their impact on the labor market.

To implement efficient and sustainable plans, we propose two important principles: Make the costs and benefits of educator pension plans transparent, and clearly tie benefits to contributions. Allow us to explain our reasoning.

In many respects, current defined-benefit systems—which characterize virtually all teacher pension plans—are opaque. This is true of the funds themselves, where complex and sometimes dubious actuarial methods make it difficult to know their true fiscal state. But it is also true for the educators relying on them to pay for their retirements and who rarely know what their plans are worth. By contrast, holders of 403(b) or 401(k) accounts typically know exactly what their account balances are at any point in time and, importantly, how rapidly contributions to their accounts are accruing. To provide the same transparency to defined-benefit participants, plans should annually disclose to each member the current-dollar value of the expected stream of future benefits—in other words, the cash value of his or her annuity, or “pension wealth.” These annual reports should also show projected values for educators as they move through their careers.

One of the core principles of compensation design is that a dollar of benefits should be worth at least a dollar to the employee. Educators and policymakers need to have a clear understanding of the dollar value of these benefits and the possible trade-offs between their current salaries and their deferred benefits.

This brings us to our second point: tying benefits to contributions. Put simply, benefits paid to any teacher should be tied to the lifetime contributions made by or for that teacher. If \$300,000 has been contributed on behalf of a teacher (including accumulated returns), then the cash value of an annuity provided to this teacher should also be \$300,000.

This should be the key principle of fundamental reform, but, unfortunately, today it is routinely violated. What's more, the gap (positive or negative) between the value of benefits and contributions is rarely made clear to participants or the public. Instead, we have a complex array of pension rules that are fairly arbitrary, including the calculation of final average salary (how many years included and what factors into that calculation, for instance), the annual service “multiplier,” and the rules for eligibility to receive a pension

[← Back to Story](#)



"As states grapple with the current pension crisis, a window of opportunity is open to implement more modern and

("rule of 80," "25 and out," and so on).

strategic plans."

Since these rules are not tied to contributions, legislatures have, over the years, been tempted to enhance them without clearly telling the public, teachers, or districts the actual value of the enhancements they have made.

Our analysis shows that the current systems result in very large implicit transfers from young teachers working short teaching spells to "long-termers" who spend an entire career in the same system. This is because the value of benefits for short-termers is much less than the contributions that have been made on their behalf, while the reverse is true for long-termers. In our view, a teacher who works 10 years or 30 years should accrue pension wealth roughly equivalent to her total pension contributions and accumulated returns. It would be easy to detect any violation of this principle if teachers regularly received updates on their pension-wealth statistics.

The current system also redistributes pension wealth between groups when it is underfunded. Specifically, the contributions by and for young teachers are often used to help make up for shortfalls in contributions for older teachers.

Tying benefits to contributions would have important workforce benefits. First, it would provide rational incentives for choosing between retiring from teaching and continuing to work. Each year, an educator would accrue pension wealth in a smooth and transparent way, providing a rational addition to the annual salary she is earning. Currently, accruing pension wealth is a highly backloaded process that is concentrated at certain arbitrary points in an educator's career. Some years (say, when a teacher reaches 25 or 30 years of service) come with increases in pension wealth that are several times a teacher's salary. This provides a huge incentive to stay on the job until that pension "spike," regardless of classroom effectiveness. There is simply no economic rationale for favoring one year of work over another in this way. Nor should an additional year of work reduce pension wealth, as is the case in current defined-benefit plans after a certain point, often at a relatively young age. This penalizes good teachers who wish to stay.

Linking benefits to contributions would also eliminate the massive penalties teachers face when they move to school systems in a different state. It is well understood in the private sector that, in order to recruit and retain talented young employees, it is necessary to provide portable retirement benefits. Businesses address this through plans that start accruing pension wealth immediately or nearly so, such as defined-contribution or cash-balance plans. (We realize "defined contribution" and "cash balance" are not common parlance in the educator community, but they need to become so for an informed pension-reform debate to advance.) But most current teacher plans require five or even 10 years of teaching before vesting. And, even for vested educators, our research finds that the loss in pension wealth for those who split a teaching career between two systems is massive. In a system where benefits are tied to the cumulative value of contributions, it does not matter whether contributions have all been made in one or many jobs. Penalties for mobility are eliminated.

No question, there is more than one way to do it right—and to do it wrong. We favor cash-balance plans that generate individual-retirement accounts in bookkeeping form, with contributions from employer and employee, and an investment return guaranteed by the employer. Such plans resemble a defined-contribution plan, but without transferring investment risk or asset management to the teacher. They are transparent, offer smooth wealth accrual, and are readily annuitized at retirement, meaning converted into a lifetime payment stream, just like a traditional pension. In such a system, no one year of retirement is favored over any other. Large private employers such as IBM have converted to such plans, as have a few public employers. The **TIAA plans** that are common in higher

education are similar in operation. They have provided retirement security for generations of college professors who often spread careers over multiple institutions.

By contrast, Illinois is a cautionary example of how not to reform teacher pensions. Illinois recently implemented a two-tiered plan, with teachers hired after Jan. 1, 2011, in the second tier. Tier 2 teachers will make identical contributions (9.4 percent of their salaries) as their Tier 1 colleagues, but will have a massive cut in pension-wealth accrual over their work lives. Moreover, the Tier 2 plan exacerbates the backloading and mobility penalties in the Tier 1 plan.

By our calculations, a new teacher entering the Illinois plan at age 25 will accrue no net pension wealth until age 51. This is not an attractive offer for young, mobile teachers. These teachers will not even have Social Security to fall back on, since Illinois teachers are not covered by it.

As states grapple with the current pension crisis, a window of opportunity is open to implement more modern and strategic plans, or to make matters worse. Fundamental reforms—tying benefits to contributions and disclosing pension-wealth accrual—are what we need to fix these broken systems.

Robert M. Costrell is a professor of education reform and economics and holds the 21st Century chair in education accountability at the University of Arkansas at Fayetteville. Michael Podgursky is a professor of economics at the University of Missouri-Columbia and a fellow at the George W. Bush Institute at Southern Methodist University.