

Teacher Retirement Benefits: Defining a More Active Role for SEAs and Their Chiefs

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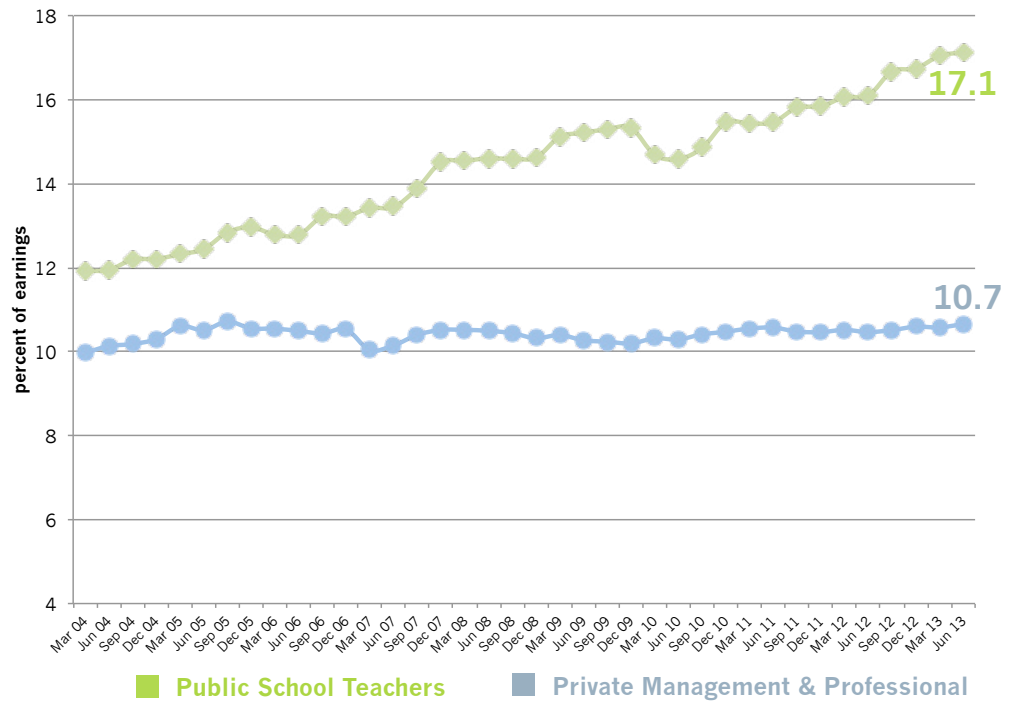
Teacher Retirement Benefits: Defining a More Active Role for SEAs and Their Chiefs

During the 2009–10 school year U.S. public schools spent \$214 billion on salaries and \$74 billion on benefits, including pensions, for instructional personnel.¹ Together, salaries and benefits accounted for nine of every ten instructional dollars spent. Aiming to make more productive use of these funds, and stimulated by federal Race to the Top and Teacher Incentive Fund grants, states and districts have launched experiments in performance pay and other compensation reforms designed to improve teacher performance, retain the best teachers, and put them where they are most needed.

One thing they have not done: talked seriously, or innovatively, about pensions. This is a lost opportunity, as retirement benefits are now emerging as a central concern and potential lever for improvement.

State education agencies (SEAs) and their chiefs are often disengaged from important policy debates about teacher pensions. The typical view—one that is reflected in organizational charts—is that teacher quality sits in one place, school finance sits in another, and the pension fund sits in a different world altogether.² This separation is counterproductive in several respects. For

Employer Contributions for Retirement Benefits and Social Security: Public School Teachers and Private-Sector Managers and Professionals



Source: Bureau of Labor Statistics (BLS), National Compensation Survey, Employer Costs for Employee Compensation, 2000, <http://www.uaedreform.org/wp-content/uploads/2000/01/Employer-contribution-chart.pdf>; authors' estimate of teacher SS contributions, using BLS estimate of SS coverage
 Note: Does not include retiree health benefits.

1. The 2009–10 school year is the most recent year for which data are available.
2. Although chief state school officers, or their designees, are often ex officio members of state teacher pension boards.

starters, pension plans are a large and growing expense for school districts and state governments, consuming scarce resources that might be put to better use. Sure, other sectors feel the pinch of retirement costs, but the cost escalation in education has been more pronounced. Data from the U.S. Department of Labor show that employer costs for public pensions rose sharply over the last decade, from 11.9 percent of salaries in 2004 to 17.1 percent in 2013 (see figure). By contrast, employer retirement benefit costs for private-sector professionals over the same time period remained nearly flat, between 10 and 11 percent of salaries. These figures do not include worker contributions, which for educators are often 5 percent or more of salary and have increased as well. Nor do they include retiree health insurance costs, which can be substantial for many school districts, given that most teachers retire before they become eligible for Medicare. Case studies in several urban districts find that these costs increased dramatically in recent years and are projected to continue to rise, sharply in some cases.³

There is also an ongoing financial threat posed by massive unfunded liabilities in many teacher pension plans. State and local pension plans are estimated to have in excess of \$4 trillion in unfunded liabilities, with K–12 pensions representing roughly half of that total.⁴ As states consider reforms, it is important to ask if current pension plans represent the most efficient way to recruit and retain a high-quality teaching workforce.

Many state school chiefs believe there isn't much role for an SEA in pension reform, in part because pension policies appear to be the domain of state pension boards or because legislatures tend to be the ones to drive change. But that sells short the SEA's potential influence. In practice, state education leaders should take an active interest in pensions, not only because of the education system's role in creating the liabilities, but also because of how pension changes might affect teacher quality and school staffing. As pension liabilities continue to rise, state chiefs need to help educate district leaders on how their decisions affect pensions in ways they may not consider. And, of course, given that pensions are a key part of teacher benefits, state chiefs should understand how incentives built into teacher retirement plans can affect retirement behavior and school staffing.

This paper is intended to assist school chiefs in playing an active, and needed, role in pension debates. We begin with a discussion of the typical teacher pension and examine the incentives it creates for work and retirement. We

3. Dara Zeehandelar and Amber M. Winkler, *The Big Squeeze: Retirement Costs and School District Budgets* (Washington, DC: Fordham Foundation, 2013).

4. Robert Novy-Marx and Joshua Rauh, "Public Pension Promises: How Big Are They and What Are They Worth?" *Journal of Finance* 66, no. 4 (2011): 1211–1249.

then briefly review the key cost drivers and their loci of control, and examine some alternative plans that have been enacted or considered. Finally, we discuss important ways in which state school chiefs can contribute. Particularly important in this regard is the development of state systems that tie pensions to teacher workforce data, particularly data on teacher effectiveness. These systems raise very interesting possibilities for using pension plans to improve the quality of the teacher workforce.

HOW TEACHER PENSION PLANS WORK

Most educator retirement plans are administered at the state level, although a few municipal plans remain (for example, in New York City, Chicago, and St. Louis). Nearly all of these state or municipal plans offer what's called final average salary defined benefit plans. Eligible teachers receive a yearly pension that is some percentage (say, 75 percent) of their final working salary for each year they are alive after retiring. The pension amount often increases by an annual cost-of-living increase of around 2 to 4 percent.

Each plan has its own rules determining employee contributions, eligibility, vesting, the pension amount, mobility (across districts and across states), and caps. In most locales, teachers must pay a portion of their salary to the pension fund, and that portion varies by system. Eligibility rules are typically based on some combination of age and years of service. In Missouri, for example, teachers are eligible for a full pension if they have 30 years of service or have reached age 60 with at least 5 years of service, or if age added to service years totals at least 80.⁵ Teachers are not automatically vested in their pensions—meaning they do not have a full right to them—when they start working. It typically takes three to five years to become at least partially vested, although the number of states that require at least 10 years is growing.⁶

Rules create powerful incentives for teachers to either stay or leave as they approach or reach particular years of eligibility. For instance, in Missouri, vesting occurs near a typical teacher's 25th year of service, and the current value of a teacher's pension can jump by \$200,000 in a single year. By teaching just one more year beyond the 24th year, a teacher earns not only a salary, but also an additional \$200,000 in pension wealth. Other incentives work in the opposite manner. The value of a Missouri teacher's pension actually drops if he or she continues working beyond age 56. Unsurprisingly, educators tend to retire at the age or experience level that maximizes pension wealth—typically when they are in their mid- to late 50s.⁷

5. Many states also have rules that permit a teacher to retire with reduced benefits at a younger age or with fewer service years. In Missouri, in a provision called "25 and out," a teacher can retire and begin collecting benefits immediately, at any age, once he or she has worked in the system for 25 years. Like similar provisions in other state plans, there is a penalty in benefits when someone retires via 25 and out. Even with the penalty, however, the provision is still quite lucrative for teachers who wish to leave the profession prior to meeting other retirement-eligibility thresholds.

6. Thirteen states now require 10 years of service for new teachers to be vested (up from nine states in 2008). See Kathryn M. Doherty, Sandi Jacob, and Trisha M. Madden, *No One Benefits: How Teacher Benefit Systems Are Failing Both Teachers and Taxpayers* (Washington DC: National Council on Teacher Quality, 2013).

7. See next page

This strong backloading of benefits in teacher pension plans has another important consequence: it imposes very high penalties for mobility. An educator who moves from state to state (or sometimes district to district) over a career will have much less pension wealth than an educator who works an entire career within a single plan, because plans don't fully honor experience from other systems. This has raised concerns, given that the educated labor force, including teachers, has become more mobile.⁸ One study finds that mobility costs from pensions inhibits the ability of urban districts to recruit high-quality school leaders and teachers from suburban districts.⁹

Table. Cost Drivers That Affect Pension Liabilities

Key cost drivers	Site where costs are typically determined
Past payments to pension fund	State legislatures
Pension fund earnings	Economic trends and fund expectations
Pension eligibility, earnings, and vesting rules	Pension plans, state legislature
Pension COLAs	Usually state legislature
Choice of plan for new entrants	Districts and state legislature
Level of employee contributions	Pension plans (some portion required by employer; the rest is often negotiated at the district level)
Final salary	Districts (via salary schedules, contracts, COLAs)
Teacher retention and attrition	Teachers and district staffing policies
Eligibility for health care before Medicare age and level of benefits	Usually negotiated by district; in some cases determined at state level

Note: COLA = cost-of-living adjustment.

7. Robert M. Costrell and Josh B. McGee, “Teacher Pension Incentives, Retirement Behavior, and Potential for Reform in Arkansas,” *Education Finance and Policy* 5, no. 4 (2010): 492–518; Cory Koedel, Shawn Ni, and Michael Podgursky, “Who Benefits From Pension Enhancements?,” *Education Finance and Policy* (forthcoming); Leora Friedberg and Sarah Turner, “Labor Market Effects of Pensions and Implications for Teachers,” *Education Finance and Policy* 5, no. 4 (2010): 463–491. The literature on how these incentives affect the quality of the labor force is limited; one study finds no net teacher effect on student test scores: Cory Koedel, Michael Podgursky, and Shishan Shi, “Teacher Pension Systems, the Composition of the Teaching Workforce, and Teacher Quality,” *Journal of Policy Analysis and Management* 32, no. 3 (2013): 574–596.

8. Robert M. Costrell and Michael Podgursky, “Peaks, Cliffs, and Valleys: The Peculiar Incentives in Teacher Retirement Systems and Their Consequences for School Staffing,” *Education Finance and Policy* 4, no. 2 (2009): 175–211.

9. Koedel, Podgursky, Shi, 2013.

Layers of Factors Affecting Pension Liabilities

Many different factors work together to affect the total pension bill, including some practices and policies that originate in districts and SEAs. (See the table for a partial list of cost drivers.) News reports often cover stories about high pension obligations due to skipped payments to pension funds or failure to meet lofty investment targets. For instance, when pension fund asset values declined during the recent financial crisis, but pension funds disbursed benefits assuming 8 percent returns, unfunded liabilities rose.

Pension plans' differing rules for eligibility, earnings, and vesting can have a large effect on total costs. Where teachers can earn a full pension at a younger age, or where the pension amount depends on a single year's earnings (versus an average of several years), pension costs will be higher. These rules are often set in the legislature and then considered fixed for all current employees. Legislatures also award cost-of-living adjustments (COLAs), which drive up pension costs further. Some states have in recent years passed legislation to lower COLAs, though in some cases those moves have been challenged in court.

In the face of rising costs, some states, like Rhode Island and Florida, have considered or are considering alternatives to the basic structure of their retirement plans for teachers. Alternatives to *defined benefit* plans include *defined contribution* plans, where (as with the 401(k) plans typically received in the private sector) employers and employees contribute funds that belong to the employee, and *cash balance* plans, where each year of their career, employees earn a fixed amount toward their pension coverage. Finally, 16 states let charter schools choose whether or not to participate in the state pension plan. In most cases, charters choose not to participate.

Contract law generally protects current teachers from changes in the basic structure of their pension plans. So in most states, changes are for new

Alternatives to Defined Benefit Plans

Defined contribution plans | Similar to 401(k)s, where employees and employers contribute funds that grow and belong to the employee. Cash balance plans—Employees earn a fixed amount toward their pension each year.

Hybrid plans | Some combination of defined benefit and defined contribution earnings.

Social Security participation plans | Some (though not all) defined benefit plans exempt participants from Social Security. In some states, proposals have been made to move teachers into Social Security.

entrants only, and decisions about those systems are determined in the legislature (and in some locales, with participation negotiated at the district level).

Also relevant to pension liabilities is the employee contribution. The more the employee contributes, the lower the state's costs. In most plans, employee contribution is set as part of the pension rules, such that employees contribute some fixed percent of their salary (say, 3 percent) to their pensions. Over the years, some districts have negotiated the employee share so the district is paying all or part of the employee portion, thereby increasing the burden on districts.

Salaries, of course, are determined at the district level. The higher the final salaries of teachers, the greater the pension costs. While state legislatures generally determine the percent of final salary that determines the pension annuity, it is the district that determines the actual final salary used in the pension benefit calculation. When districts award pay raises to very senior teachers, those pay increases translate into higher lifetime pension earnings. When districts flatten salary structures so that a teacher earns the same over a career, but more pay is loaded on the earlier years, unfunded liabilities are likely to be lower.

Another cost element that can be attributed to districts is teacher attrition and retention, yet district leaders rarely consider the relationship between their policies and practices and the resulting cost to pensions. For instance, districts often work to encourage retention of teachers early in their careers. This makes sense as an attempt to stabilize the profession. But in a district where pensions fully vest after five years, say, retaining a teacher just over that time marker costs much more over the long term than retaining a teacher who is just below it—something district leaders may not consider. At the other end of the continuum, districts may decide to wait out (rather than push out) ineffective teachers just a few years from retirement, without factoring in the huge jump in pension costs those few remaining years will add, beyond the teacher's salary.

Finally, health benefits for retired teachers create an additional retirement cost. Here again, districts generally are responsible for awarding these benefits (although in some cases the state does). The health benefit takes the form of covered health insurance between retirement age and age 65, at which time the retired teacher becomes eligible for Medicare. Since the retirement age of the vast majority of teachers is well below 65, this creates a large demand for retirement health insurance. Where state pension plans allow lower retirement ages, these costs are higher.

THE ROLE OF STATE CHIEFS AS SYSTEMS STRUGGLE WITH RETIREMENT COSTS

State education leaders often believe that high pension costs are not their responsibility—understandably, given that many key cost factors are under the control of the state legislature. Education leaders can lobby for change, but ultimately the pension policy is not their charge. And practically speaking, elected state chiefs may be relieved to avoid the ire from labor unions that comes from supporting pension changes. However, there are still roles they can play to mitigate the growing problem of retirement costs.

Role #1: Illuminating Retirement Plan Effects on Teacher Quality

Pension fund boards considering changes in plans typically focus only on the fiscal effects of the changes, not the labor market or teacher quality effects. However, pension plan reforms can dramatically affect school staffing. As described earlier, rules on vesting and retirement ages can serve both to keep teachers in the workforce during certain years and to push them out in others. Furthermore, where pension plans do not allow portability of benefits, more mobile teachers may prematurely leave the profession. SEAs can examine pension rules and proposed changes for their likely effects on districts' access to labor. Where pension plans constrain the workforce, the state's school districts may face a smaller pool of prospective teachers. Good data on topics such as the age distribution of retiring teachers and hiring data for out-of-state teachers will help leaders explore the effects—actual and potential—of various pension rules.

It isn't just the size of the talent pool that matters, but also how the pension plan affects teacher quality. Those defending traditional defined benefit plans have argued that pension changes threaten the quality and stability of the workforce, but there is scant data to support that argument.¹⁰ It is possible that teachers vary—by subject matter, grade level, gender, effectiveness—in how they respond to pension changes. SEAs should evaluate retirement patterns in these terms, and in response advocate for retirement systems that work to retain the best teachers, especially those in high-need fields, such as special education and STEM subjects (science, technology, engineering, and mathematics).

Another important issue that deserves consideration is the trade-off between generous retirement benefits and current pay. In the face of rising college debt and housing costs, young people considering a career in teaching (especially

10. An example of this argument is found in materials produced by the Illinois Federation of Teachers and available on their website: www.ift-aft.org/memberresources/TeachersPreK-12/Pension-sTeacher.aspx (accessed October 21, 2013).

STEM majors with good nonteaching alternatives) may prefer more up-front remuneration rather than a generous, but very distant, retirement package.¹¹ In fact, one study found that younger teachers would rather earn 17 cents more now than have \$1 added to their pension fund for later.¹² Such a finding suggests that if some of the current spending on pensions were reallocated, perhaps to salary, it would be easier to recruit and retain younger teachers.

Leaders can leverage pension changes to support a talent-driven agenda only if they better understand the effect of the current retirement system on teacher talent. For example, some states offer plans designed to keep teachers teaching past retirement (often called Deferred Retirement Option Plans, or DROP plans). Generally these plans are open to all teachers, regardless of quality. Chiefs might call for policies that make these plans available only to the best teachers or to those teaching in high-demand fields. Plans could be designed to be actuarially neutral in their effect on pension system finances. Indeed, it is possible that a well-designed plan could actually raise workforce quality and lower pension system liabilities.¹³

So while pension boards and legislatures may be focusing primarily on long-term cost implications, state education chiefs can be examining proposals with the lens of enhancing human capital for the state's schools.

Role #2: Building Transparent Systems That Link Pension Earnings to Teacher Quality Data

Planning for the state's teaching needs requires solid information on how retirement benefits affect human capital. It is rare that state school chiefs have access to basic descriptive statistics on pension systems. For example, many chiefs do not have ready access to the number of teachers retiring from high- or low-performing schools or from high-demand fields, or whether retirement rates differ by teacher effectiveness. That is partly because retirement data are typically housed in state or municipal worker data systems, while teacher data are housed in the SEA. As states face continued pressure from pensions, however, creating access to such data is critical to understanding differential effects of pension rules and then tailoring retirement plans to enhance the quality of the teaching workforce.

11. McGee and Winters examine the potential for cost-neutral changes in total teacher compensation in large school districts. A scaled-back retirement plan for teachers, more in line with private-sector standards, would permit a substantial increase in pay for younger teachers. See Josh McGee and Marcus A. Winters, "Better Pay, Fairer Pensions: Reforming Teacher Compensation," *Civic Report* 79 (September 2013): 1–32.

12. Maria D. Fitzpatrick, "How Much Do Public School Teachers Value Their Retirement Benefits?" (unpublished manuscript, 2012).

13. Fitzpatrick ("How Much Do Public School Teachers Value Their Retirement Benefits?," unpublished manuscript, 2012) reports evidence suggesting that public school teachers place a lower value on future pension wealth than discount rates used by pension funds. This means that a bonus program could be designed that would entice highly effective teachers to remain on the job and defer retirement at much less cost than the loss in pension wealth for the teacher. This would raise student achievement overall and reduce pension fund liabilities.

State education chiefs can lead the development of statewide data systems that link pension earnings and teacher data (and, in some locales, student data). In Tennessee, the SEA has been matching teacher effectiveness data with pension system retirement records and finding that teacher retirement behavior varies across levels of teacher effectiveness. As the data systems mature in other states, those data can be woven into pension systems to inform retirement policies that more proactively recruit, retain, and motivate quality educators.

Role #3: Alerting Districts to Cost Factors Controlled at the District Level

SEAs can do much more to call attention to how district decisions and practices affect pensions. Districts can contribute to rising pension costs through salary structures and through practices that affect teacher retention and attrition. SEAs can help districts act responsibly by educating them on the implications of their choices. For instance, where districts award across-the-board salary raises in the form of a percentage raise (say, 4 percent), the most senior teachers receive the largest pay bump in dollars, yielding higher final salaries and a corresponding increase in the pension annuity. If, instead, districts awarded the same total funds in the form of a fixed dollar amount to each teacher, the pension implications would be lower, even though the raise could be set up so that the lifetime wage earnings of a given teacher would be the same.

One way to bring to light the implications of district salary awards that unduly drive up pensions would be to require districts to compute and report the changes in pension liabilities associated with salary awards. A \$1 increase in final salary is generally estimated to have more than a \$10 impact on pension liabilities—yet such calculations are unknown in most districts.

CONCLUSION

Given that state school chiefs have little formal leverage to make changes to pension plans, it is understandable that they have not taken a lead role in influencing pension policy. But pension plans matter to the work of SEAs and their chiefs, especially considering the financial threat imposed by the rising cost of retirement benefits and the powerful effect pension system incentives have on shaping the teaching workforce. Toward that end, state school chiefs should take on new roles in pension debates and participate in a way that leverages their position and interests in light of the existing barriers.

As SEAs work with their systems to improve productivity, it is important that retirement benefits not be overlooked. Large sums of money are invested annually in retirement benefit systems, and these systems need to be scrutinized with an eye toward maximizing school performance. There are many different pension changes afoot. Some are better for students than others, and state school chiefs can play an important role in promoting those that are good for students as well as educators.