How Will Teachers Fare in Rhode Island's New Hybrid Pension Plan?

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Faced with at least a $7 billion gap between benefits promised to public-sector employees and funds set aside to finance them, Rhode Island lawmakers transformed their state pensions in 2011. Like nearly all other states, Rhode Island provided employees with a traditional defined benefit (DB) pension plan that based lifetime retirement benefits on years of service and final average salary. The Rhode Island Retirement Security Act of 2011 replaced the pure traditional pension plan with a smaller DB pension that is supplemented by a 401(k)-type, defined contribution (DC) component. Under this new component, employees and employers must both contribute to employees' retirement accounts, which are invested and earn returns. Employees withdraw the accumulated balance when they leave state employment, which they may use to purchase an annuity in the private sector.

The new hybrid plan has been controversial. Advocates contend that the recent reforms are necessary to make the system solvent and to protect taxpayers from future unsustainable costs by sharing the risk of uncertain investment returns with state employees. Proponents also maintain that the new hybrid plan will enable most state employees to live comfortably in retirement and could be a blueprint for pension reform around the country. Some critics, however, claim that the reforms will weaken retirement income security, subject employees to unnecessary risk, and only save the state little if any money.

Our recent analysis shows that most public school teachers—the largest group of public employees in Rhode Island—will fare better in the new hybrid pension plan than the former stand-alone DB plan (Johnson et al. 2014). Two-thirds of teachers projected to be hired in 2014 will accumulate more lifetime retirement benefits in the new plan than they would have earned in the old DB plan (figure 1). Teachers with relatively short tenures will fare especially well. All teachers with less than 10 years of service will accumulate more benefits in the hybrid plan than the former plan, which requires teachers to work a full decade before earning any pension benefits. About three-quarters of teachers with between 10 and 20 years of service will also gain from the new plan. However, most teachers with more than 25 years of service would have done better in the old stand-alone pension.

Why Don't Participants Do Better in the Stand-Alone Traditional Plan?

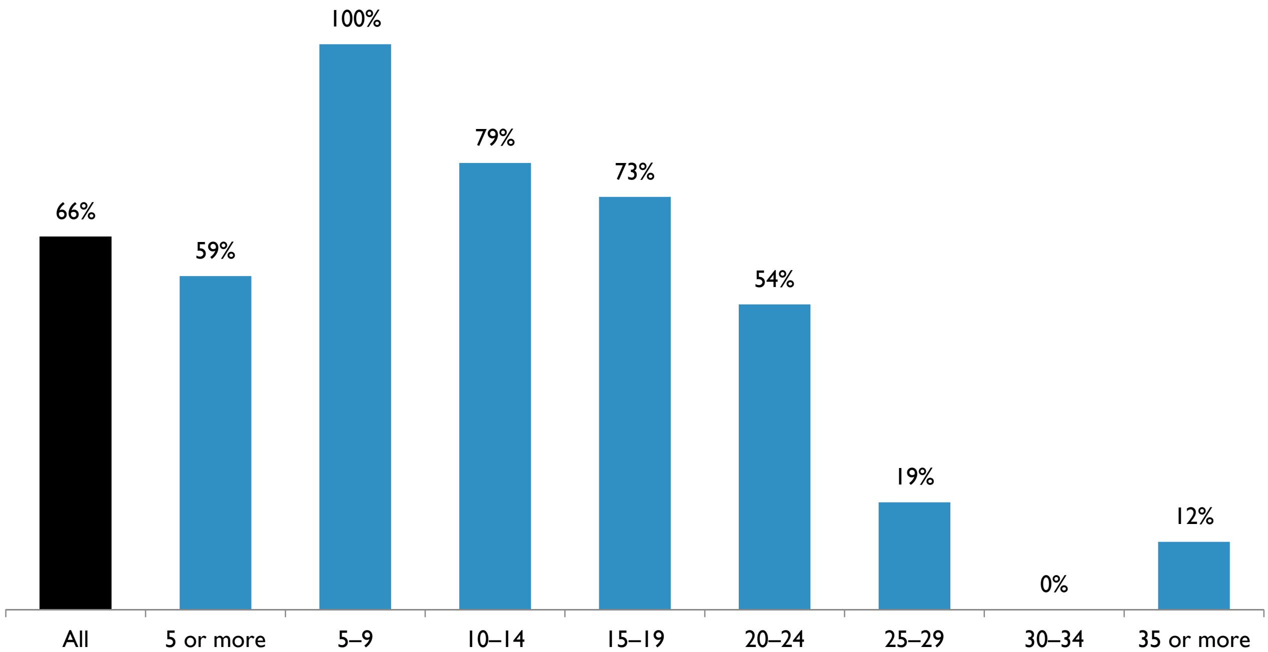
Most teachers must participate in the old DB plan for many years to earn a substantial pension. Benefits for teachers who separate early are based on the relatively low salaries they received at younger ages, not the higher salaries typically received at older ages. The defined benefit plan does not allow teachers to begin collecting their pensions until age 62. When they separate at younger ages, their benefits are frozen until they begin collecting; they do not grow with interest, inflation, or productivity gains. By contrast, account balances in DC plans may continue to grow with investment returns until retirement, even for teachers who have left the public school system.

The former stand-alone DB plan requires teachers to contribute 9.5 percent of their paycheck each period. Those contributions are often worth more than the value of future pension benefits. For example, we estimate that teachers hired at age 25 must work 26 years before their pension is worth more than what they have contributed. Teachers may choose to have their contributions refunded when they separate from the school system instead of collecting a pension later, but they do not receive any interest on their contributions. In effect, they are making interest-free loans to the plan, subsidizing benefits received by longer-serving teachers. Overall, about half of newly hired teachers get nothing out of the old stand-alone DB plan. The hybrid plan works better for teachers who spend less than a full career in the plan because it provides a portable benefit that allows them to accumulate retirement savings. It also reduces employee contributions to 8.75 percent of salary, with only 3.75 percent going to the DB portion of the plan. The remaining 5 percent goes to employees' DC accounts. Additionally, the DB portion of the hybrid plan vests in 5 years, not 10 years as in the old plan.

Conclusions

Defined contribution plans—the dominant employer-sponsored retirement plan in the private sector—can play an important role in the reform of public-sector pensions. Although relatively few participants in private-sector 401(k) plans have amassed much retirement savings, their poor performance stems largely from low contribution rates. This is a much less serious problem in the public sector because most public employers mandate employee contributions. DC account balances vary with investment returns, but prudent investment strategies can minimize that risk. Many public-sector employees would fare better in hybrid plans that included both DB and DC components than in a stand-alone DB plan.

Figure 1. Percentage of Teachers Expected to Fare Better in the New Hybrid Plan than the Stand-Alone Defined Benefit Plan by Final Years of Service



Source: Johnson et al. (2014).
Note: Estimates are for teachers hired in 2014 who earn the average salary among plan participants for their age and years of service. Investment returns for the defined contribution component of the hybrid plan are randomly drawn from a distribution that generates expected long-term annual returns of 7.38 percent. Future benefits are discounted at 5 percent a year. The annual inflation rate is assumed to be 3 percent.

Reference

Johnson, Richard W., Barbara A. Butrica, Owen Haaga, and Benjamin G. Southgate. 2014. "How Will Rhode Island's New Hybrid Pension Plan Affect Teachers?" Washington, DC: The Urban Institute.

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