You Decide: Are There Changes Ahead For State Pensions?

By Dr. Mike Walden, North Carolina Cooperative Extension: My wife has now been retired for ten years. She taught elementary school for 32 years, usually putting in 12 to 14 hour days when classroom time, after-school grading and lesson plans are included. She was a teacher for so long that many times she taught the children of former students. She took pride in the accomplishments of her pupils, and even today is thrilled to see some of them – of various ages – about town.

You can tell I am proud of my wife and happy she gets to pursue her hobbies and public service activities now that she is retired. But I've also noticed another change in her. After largely ignoring it while she was working, she now is very interested in the public pension system for teachers and state worker retirees. So any story about possible changes in North Carolina's public pension plan immediately gets her attention.

Recently I've been getting an earful of questions from my wife about the state pension. This is because there have been some ideas and proposals put forth for changing how the system is operated and how payments would be made to future retirees.

North Carolina's state pension plan is big – covering about 900,000 working and retired individuals and with almost $100 billion in assets. It is considered to be one of the most financially sound public pension systems in the country. But like all public pension plans, it does face some issues.

One is the simple fact that retirees are living longer – indeed longer than when the pension rules were established. This means that most pension systems face an expected shortfall of money to meet pension promises. Some of these estimated shortfalls are enormous – such as for Illinois' public pensions. North Carolina's calculated shortfalls are much less, but still, they do exist based on analysis by academic and other professional evaluators.

The other issue is management fees. In an effort to boost earnings from the pension investments, many public pension funds – including North Carolina's – have hired professional investment companies to manage at least some of their pension money. However, these management companies charge fees that – in the case of North Carolina – can total hundreds of millions of dollars annually. The question is whether such fees more than pay for themselves in higher earnings. Some analysis suggests the management companies may not always deliver.

There is currently some discussion among policymakers in North Carolina about how to address these two issues. Regarding the potential for a shortfall in the ability of the state pension to pay all that has been promised to retirees, one idea is to change the fundamental definition of the state pension.

North Carolina currently operates a "defined benefit pension plan." In this plan a retiree's pension is based on a formula using an average of the retiree's high annual salaries and the retiree's years of service.

One idea is to change the pension plan to a "defined contribution" system. Here the retiree's pension is derived from how much the retiree and the state contributed and how much the pension fund earned. Thus, there is no guaranteed pension payout once the worker retires. This pension system would help reduce – and eventually eliminate – pension shortfalls. It should be emphasized that, under the proposals that have been offered, such a change from a defined benefit pension to a defined contribution pension would only affect newly hired employees.

Most people consider a defined benefit pension plan to be better than a defined contribution pension plan due to the former guaranteeing a pension amount. In order to cope with pension problems, many private businesses have changed from defined benefit to defined contribution plans.

Still, there is the worry that switching to a defined benefit plan for new employees would make it harder for the state to recruit workers. However, countering this worry is some research suggesting that – because retirement is so far in the future for most newly hired employees – they place a relatively low value on retirement plans. Also, the state could increase worker salaries as one way to compensate for the change in pension plans.

The second issue - about the value of paying higher fees to investment firms for managing the state pension funds - is part of a larger debate over the value of active investment management. There is a substantial body of academic research suggesting it is extremely difficult for investment managers to consistently "beat the market averages." This research therefore calls into question whether paying higher fees leads to higher investment returns. Those who accept this line of reasoning argue the state pension system would do just as well – and maybe even better – if it was invested in set of low-fee, diversified mutual funds covering all the major kinds of investment types.

So state pension plans – including North Carolina's – are facing some major decisions about both the type of pension plan and the way those pension plans are invested. There is one thing certain in these decisions. If there are looming problems, addressing them now is a way of limiting their severity.

So - you decide - whether, when and how we should act on state pensions.

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