Recruitment and Retention in the Public Sector: The Role of Pensions

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Abstract

Employers and employees alike have long appreciated the role that retirement plans play as part of a competitive compensation package. In the public sector, defined benefit (DB) pensions play an especially important role in human resource strategies. DB pensions have been shown to be an effective retention tool, and government employers are well suited to offer them. Traditional pensions are also highly valued by public sector employees. Because these systems serve employees, employers, and taxpayers well, the public sector is unlikely to mimic the trend away from DB pensions witnessed in the private sector.

Introduction

Employers and employees alike have long appreciated the role that retirement plans play as part of a competitive compensation package. Employees value retirement plans because they provide a more cost-effective, streamlined way to build retirement wealth than if they had to do the job on their own. Employers, as well, care very much about employees' retirement security prospects if for no other reason than the fact that employees who lack the financial means to retire may simply "retire on the job," with potential negative productivity impacts for the employer. But employers also realize that retirement plans, as a form of deferred compensation, can be structured in a way as to create incentives that enhance their human resources objectives.

Defined benefit (DB) pensions play an especially important role in the human resource strategies of government employers. DB pensions have been shown to be an effective retention tool, and government employers are well suited to offer them. At the same time, DB pensions seem to be highly valued by employees in the public sector. Pensions' "staying power" in the public sector stems from the fact that these systems serve employees, employers, and taxpayers well. This suggests that the public sector is unlikely to mimic the trend away from DB pensions witnessed in the private sector.

Why Public Employers Offer Retirement Benefits

The principal goal of a retirement plan is to provide benefits that will enable an employee to cease working at some point and have a source of income to sustain himself or herself for the remainder of life. In the public sector, employees' retirement income adequacy is a special consideration, because the state, as the provider of last resort, will ultimately be responsible for those who can no longer work and require assistance to meet basic needs. Thus government employers (and thus, taxpayers) can either "pay now" by providing an adequate retirement plan for their workers or "pay later" in the form of providing public assistance. Indeed, concerns for elderly state and local employees' retirement security were a primary motivating factor for the establishment of public retirement systems. During the Great Depression Social Security was established for most private sector workers, but the legislation left out public employees. So many states took action in developing their own retirement systems for their public servants. Between 1931 and 1950, nearly half of the large public employee pension plans surviving today were established; 45 states had retirement systems in place by 1961 (Clark, Craig, and Ahmed 2008). But the social goal of providing for retirement security is not the sole factor government employers consider when it comes to designing retirement benefits.

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Workplace retirement plans are a "fringe benefit" that enhances the overall compensation package offered to employees. Thus, one would expect that with all else equal, workers would prefer a job with a retirement plan to one without. But retirement benefits are different from some other "fringe benefits" in an important respect. They represent deferred compensation. In other words, unlike wages, paid vacation days, or health care benefits, retirement benefits are not enjoyed until years or even decades into the future.

Because of their deferred nature, retirement plans can have the effect of encouraging employee commitment to the employer. For instance, a benefit design where long-tenured workers earn benefits more rapidly the longer they stay on the job can have strong effects on retention. An example of this type of plan design is the traditional "final pay" DB pension plan. In such a plan, the employee's retirement benefit is typically determined by a simple formula that multiplies the employee's final salary (usually averaged over the final three to five years of employment) by their number of years of service, and then by a set factor, or "benefit multiplier." In 2006, the median benefit multiplier for statewide pension plans was 1.85%.[1] So, in that case, an employee with a final average salary of $50,000 and 30 years of service will receive an annual benefit of $50,000 x 30 x 1.85%, or $27,750. The longer one stays on the job, the more benefits one earns, but in addition, the value of the pension grows with each pay increase. This is the dominant type of plan in the public sector—92% of public sector workers are covered by a DB plan (Munnell, Haverstick, and Soto 2007).

We would expect that employers would opt for this type of plan design where the nature of the work and workforce indicates that retention is to be valued, for example, where workers' productivity increases with their tenure or where recruitment costs are high and the employer wishes to keep turnover rates low. This design might also be desirable in cases where workers are called on to make human capital investments that are not transferable to other employers or occupations. In such a case, the pension provides a "compensating differential" that makes up for the fact that a worker would incur labor market penalties by leaving the job. Indeed, these descriptions fit many of the jobs that make up the public sector workforce—from teachers, to public safety officers to judges.

In other settings, employers may not value retention as highly, such as in jobs where productivity does not increase along with tenure or turnover does not present a large financial burden. In still other circumstances, employers may value retention but have other tools at their disposal to encourage it (e.g., job ladders, promotions, stock-based compensation), and so the firm may not want or need to design a retirement plan to promote retention. In such cases, an employer may opt not to offer a retirement program, to offer a more "bare-bones" type of plan, or to design a plan where benefits accrue in a steady fashion over a career (with no acceleration toward the end of one's career). Cash-balance defined benefit plans or defined contribution plans typically have more steady benefit accrual patterns. These types of design have become more common in the private sector.

In empirical studies, economists have found strong evidence that DB pensions help firms retain workers. Turnover rates for workers with pensions are about half those of workers without pensions. Allen, Clark, and McDermed (1991) found that workers with pension coverage had an average tenure of 8.8 years at a single job; those without pension coverage stayed just 4.1 years. Friedberg and Owyang (2004) found a similar link between DB pension coverage and job tenure—workers with a DB plan expect to remain on the job 5.5 to 7.5 years longer than workers with no pension. Other economists also find that DB pension plans exert significant retention effects, even controlling for worker demographics and employer characteristics.[2] Allen, Clark, and McDermed (1993) attributed this lower turnover in part to the "capital losses" workers in DB plans would incur by quitting before retirement—in other words, by leaving before retirement, workers sacrifice some portion of the benefits that otherwise could have been earned had they stayed on the job. These authors also found that in addition to a retention effect, there appears to be an attraction/selection effect at work as well; workers who are more likely to stick with a job are more likely to take a job that offers a DB pension plan in the first place. This could be because workers who are looking for a career (rather than just a short-term job) seek out employers who offer pensions, and/or it could be because employers who offer pensions are more careful in their selection of workers.

Ippolito (1997) also focused on the attraction effect of pensions and considers how employers who offer retirement plans use these as tools to select workers who are more forward-looking. Ippolito found that workers who discount the future less (that is, who delay gratification and are less focused on immediate rewards) are better, more attractive workers. Traditional DB pension plans, which hold out greater future rewards based on tenure, would be more attractive to these types of employees than to "high discounters" who are more focused on current rewards.

Finally, a more recent study by Steven Nyce (2007) found that both DB and DC plans seem to have a positive effect on retention but that the effect is significantly larger for DB plans. He also found that DB pension plans "significantly increase employees' commitment to their organizations," while coverage under a DC plan has no effect on employee commitment. Interestingly, these results are strongest among younger workers, who are often assumed to find DC plans more attractive. Nyce's findings suggest that employers who are looking for the best value for each compensation dollar should seriously consider DB pension plans, since the enhanced commitment effect of DB plans could translate directly to the bottom line through enhanced productivity.

These findings suggest that DB pensions are an important tool for government employers. Public employers have unique human resources objectives. Unlike private companies, which exist to make a profit for shareholders, governments exist to provide essential services—safe streets, clean drinking water, good schools—to citizens and residents. Because government entities tend to be more permanent than private sector firms, long-term attachments between employers and employees may be both more feasible and more desirable. Indeed, employment tends to be much more stable in the public sector compared with the private sector, where layoff and quit rates are three to four times higher (Greenfield 2007). Researchers at Boston College have also found that public sector employees seem to be more attached to their jobs than private sector workers. The research shows that the tenure of public sector employees has actually increased over the past 30 years, while that of private sector employees has decreased, so that by 2004 the median job tenure was 7.7 years for public sector employees, compared to 5.0 years for private sector employees (Munnell, Haverstick, and Soto 2007).

DB pensions provide incentives for highly skilled workers (whether they are teachers or computer programmers) to stick with public service instead of seeking out possibly better-paying positions in the private sector. Moreover, to the extent that many occupations that exist in the public sector have few private sector counterparts (e.g., public safety, criminal justice), DB pensions provide incentives to make necessary human capital investments. Thus, DB pension plans, which are highly effective at fostering attachments between workers and their jobs, are consistent with public employers' human resources goals.

How Public Employees View Pensions

A major difference between public and private sector workers is the relative importance they place on monetary and nonmonetary rewards from work. Houston (2000) found that public employees are more likely to place a higher value on intrinsic rewards—feelings that their work is important and a sense of accomplishment—whereas private sector workers prioritize higher pay and working fewer hours. These differences in job preferences stem from the inherent nature of public sector organizations that are established to fulfill "complex social functions," supplying goods and services that cannot necessarily be bought and sold in a private market. As such, those who enter public sector jobs may place a higher value on carrying out acts for the good of their community, and the resulting internal satisfaction that these acts provide, than their private sector counterparts (Wright 2001).

That doesn't mean that compensation is unimportant. Public sector workers seem to care more about their retirement benefits than private sector workers, largely preferring DB plans to other forms of retirement income (Munnell, Haverstick, and Soto 2007). This is consistent with more general research findings that DB pension plans are more highly valued by certain kinds of workers—specifically, older workers and union members (Nyce 2007; Almeida, Kenneally, and Madland 2008). Public sector workers fit both of these categories. They tend to be older than private sector workers—in 2005, 52% of state and local workers were over the age of 45, as compared to just 43% of public sector workers. And public sector workers are more than three times as likely as private sector workers to be union members (Munnell, Haverstick, and Soto 2007).

Recent public opinion research reinforces that DB plans are highly valued by public employees and are an important consideration for those who choose a career in public service. For example, an analysis of a nationally representative survey conducted by Hart Research in 2006 indicated that public employees were much more favorable to traditional DB pensions and much less likely than other workers to express a preference for 401(k)-type plans. When asked about proposals to switch public employees out of DB plans and into 401(k)-type plans, public employees were strongly opposed (Almeida, Kenneally, and Madland 2008). A 2003 survey commissioned by the Society of Actuaries (SOA) also found that public employees place a very high value on their pension programs. The survey, conducted by Matthew Greenwald and Associates (2004), found that almost two-thirds of public sector employees stated a preference in favor of DB pensions as compared with DC plans.

But how do we know that this result is not one of framing? In other words, because employees are more familiar with the type of plan they already have, could not this familiarity translate into a stated preference? Indeed, framing effects can be real. Employers or retirement plan providers often provide education to employees about benefits on offer, and thus employees may have more information about the program they are offered than about alternatives not on offer. For instance, the SOA survey found that workers and retirees tended to express a preference for the type of plan they already had—those with a DB pension expressed a preference for DB plans, and those with a 401(k) expressed a preference for DC plans. Employees who had both a DB and a DC plan were evenly split in their preferences when asked which type of plan they prefer (Matthew Greenwald & Associates 2004).

But another explanation is that public employees' preferences for DB pensions are "revealed" preferences—that is, they reflect a true preference that has been realized by deliberately seeking out an employer that offers this type of plan. Real world tests of this explanation indicate that it has merit. Time after time, when public sector employees are given a choice between a traditional DB pension and a DC plan, overwhelmingly they choose the DB plan. For example, in a small number of states, such as Ohio, Florida, South Carolina, Colorado, and Washington, public employees can choose whether they wish to participate in a DB plan or a DC plan. A mere 3.3% of employees in the Ohio Public Employee Retirement System (PERS) elected the DC plan over the DB pension when offered. In Florida and in South Carolina, DC takeup rates have been higher, with about one in five newly hired employees choosing the DC plan. However, there seem to be distinct patterns along occupational lines in DC plan election. In South Carolina, for instance, those employed by the state's colleges and universities were three times as likely to opt for the DC plan. This could be due to the fact that university employees are more likely to expect to leave their jobs or that they feel more comfortable with the role of managing their own money for retirement. It is important to note that in most states, employees who do not make any affirmative election of one plan or another will default into the DB plan. This might suggest that the DB takeup rates of 80% to 90% that are typically seen are driven largely by employee inertia. But the experience of Washington State suggests otherwise. Here the default option is a combined DB and DC plan. Almost two-thirds opted out of the default program in favor of an all-DB plan (Olleman 2007).

The case of West Virginia is even more interesting. In 1991, the Teachers Retirement System (TRS), a DB plan, was "frozen" to new hires, all newly hired teachers after 1991 were enrolled in a new DC retirement plan, the Teachers Defined Contribution Retirement System (TDC; Consolidated Public Retirement Board & Buck Consultants 2008). Over time, however, it appeared that the DC plan was not providing teachers the opportunity to accumulate sufficient savings for retirement (Levitz 2008). In 2005, the state, concerned that too many teachers would have inadequate resources to retire, closed the TDC, and all newly hired teachers were enrolled in the "old" TRS DB plan (Consolidated Public Retirement Board & Buck Consultants 2008). Then came the question of what to do about the teachers hired between 1991 and 2005 who had been enrolled in the TDC. Initially, there was an attempt to transition all these teachers into the DB plan, but in the face of legal challenges, this route was abandoned. Subsequently, the state determined that teachers should make individuals elections as to whether to remain in TDC or transfer to TRS. At least 65% of the group would need to vote in the affirmative in order for any switch to occur (Kabler 2008a).

On July 1, 2008, West Virginia certified the results of a vote in which 79% of teachers voted in favor of switching to the DB plan. An overwhelming number of younger teachers—over 75% of teachers under the age of 40—decided to make the switch to the TRS (Kabler 2008b). This result was viewed by many as surprising, since it is often assumed (incorrectly as it turns out) that younger workers prefer DC over DB plans.

Pensions and Fiscal Responsibility

Finally, because public employers answer to the taxpayer, the goal of fiscal responsibility is an important one. Because public employers want to offer retirement plans that are cost-effective and make efficient use of tax dollars, they rely on DB pension plans. Because of their group nature, DB pension plans stretch each dollar much farther than DC plans, based on individual accounts. The cost differential can be dramatic—a recent analysis showed that to provide a given level of retirement benefit, a typical DB plan could do the job at about half the cost of a DC plan (Almeida and Fornia 2008). A related consideration is the effectiveness of DB plans in actually achieving retirement income adequacy goals. After all, if a retirement program is not achieving its goal—allowing employees to retire—it cannot be considered an effective use of taxpayer funds. A growing body of retirement research indicates that employees with DB pension plans are generally better positioned to achieve a secure retirement than those who must rely on a DC plan alone (Almeida 2008). And the experience of two states, Nebraska and West Virginia, suggests that this is also true with respect to public sector workforces. Both these states experimented with offering DC plans to some public employees, but they ultimately abandoned those plans when it was determined that the DC plans were providing benefits that would be sufficient to allow employees to retire with an adequate income (Almeida, Kenneally, and Madland 2008).

Looking Ahead

Over the past three decades, private sector employers have become less likely to offer traditional defined benefit pensions, opting instead to offer defined contribution retirement savings accounts, like 401(k) plans. Three decades ago, DB pension coverage in the private sector was very similar to that in the public sector, but today, only about a third of private sector employees with a retirement plan at work are covered by a DB plan (Munnell, Haverstick, and Soto 2007).

This divergence in DB pension coverage in the private and public sectors has prompted policymakers in some states and localities to explore whether they should follow the private sector trend in recrafting retirement programs. But states that have investigated carefully the question of whether to close down their DB pension programs have concluded that this is the wrong direction for public policy. First, abandoning DB plans would mean giving up their demonstrated benefits on retention. Second, since public employees value these programs so highly, switching to DC programs for newly hired employees could harm recruitment efforts. And third, the cautionary examples of states like West Virginia and Nebraska have served as a warning that states and localities should "look before they leap" when it comes to redesigning retirement benefit plans—the risk of squandering valuable taxpayer dollars on less efficient programs that fail to meet their stated objectives is a real one.

Because DB pension plans meet the goals of employers, employees, and taxpayers, we can expect that they will continue to be a durable feature of compensation arrangements in the public sector. The impending retirement of the Baby Boom generation will create pressures for various levels of government who need to hire their replacements (Willett and Gilding 2001). Government entities will have to compete for talent with private sector employers—who may be able to offer higher salaries, stock options, or profit-sharing programs—while meeting their fiscal responsibilities to make the most of taxpayer dollars. The good news is that DB pension plans are a proven, fiscally responsible way to attract and retain skilled workers. Indeed, the widely publicized trend away from DB pension plans in the private sector may even help public sector employers compete for talent more effectively by offering a unique benefit that is highly valued by skilled employees.

Endnotes

1. This is for Social Security–eligible employees. Benefit levels for employees who do not participate in Social Security are typically higher. See Brainard, Keith. 2007. *Public Fund Survey Summary of Findings for FY 2006*. Washington, DC: National Association of State Retirement Administrators and National Council on Teacher Retirement.

2. For a review, see Gustman, A.L.O. Mitchell, and T.L. Steinmeier. 1994. "The Role of Pensions in the Labor Market: A Survey of the Literature." *Industrial and Labor Relations Review*, Vol. 47, No. 5, pp. 417–38.

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