THIRD WAY

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Taking Immediate Steps to Provide Teachers with a Secure Retirement

Tamara Hiler
Deputy Director of Education
@TamaraHiler

Lanae Erickson Hatalsky
Vice President for the Social Policy & Politics Program
@LanaeErickson

Takeaways

This report calls for three federal actions which would make it easier for states to provide retirement protections that work for all teachers:

- Creating a FICA replacement plan for cash balance and other hybrid retirement systems.
- Explicitly including vesting times in FICA replacement plan formulas.
- Shortening vesting times for teachers to more closely match the protections afforded to private-sector employees.

Over the next decade, the U.S. will hire approximately 3 million new teachers. Most will not earn a pension. While there has been some conversation about how badly pensions are underfunded, there is another problem that is at least as serious: unless a teacher remains in the profession for many years, or even decades, the current system is a rip-off. To deal with chronic underfunding, state and local governments have lengthened vesting times, upped contribution levels, and changed benefit formulas to penalize those who don't spend a lifetime teaching in order to pay generous benefits to those who do. No private plan would be allowed to behave this way. Efforts to reform teacher pensions at the state level to fix this problem have been hampered by outdated federal regulations that preference the status quo.

The Problem

There are 5 reasons why teacher pensions are generous in theory, but nonexistent in practice for most of today's teachers.

1. Vesting times for teachers are going up.

Unlike for private employers, the federal government puts few limits on how long public employers can make their employees wait in order to vest in their retirement. States have the leeway to determine their own vesting periods up to 20 years, and although today the median wait time for teachers is five, 19 states require their teachers to spend at least 10 years in the classroom before they can even vest at the minimum level in their retirement. [1] In fact, with the recent economic downturn and rapidly increasing underfunded pension liabilities, the recent trend for states is to actually *increase* those vesting times so that fewer and fewer teachers can collect; out of the 13 states that have changed vesting times in the last five years, only one (AZ) actually *lowered* this requirement for its teachers. [2]

This trend towards lengthening vesting periods for teachers comes in sharp contrast to changes around the rules governing retirement plans for private sector employees. Under the federal guidelines that set minimum standards for private sector retirement plans, *Employee Retirement Income Security Act* (ERISA), vesting requirements have actually gone *down* over the last decade to provide greater protections to workers. While these rules used to require vesting times not to exceed 20 years, in its most recent iteration, ERISA lowered vesting time requirements to say that most private sector employees must at least partially vest by two years or fully vest by three. [3] So while the vast majority of American workers are being afforded greater retirement security under federal law—and better assurances that they will get to keep the money their employers are contributing off the top of their salary—teachers have found themselves at the whim of state legislators that in most cases are making it harder for them to qualify for even a minimum pension.

2. Staying time for teachers is going down.

Nearly half of all new teachers now leave the profession within the first five years. They aren't alone—the landscape of the American workforce has changed dramatically over the last few decades, with fewer and fewer workers choosing to stay long-term in any one job or career. Our recent poll of college undergraduates demonstrates that "job hopping" is the new norm for Millennials: 43% said they planned to stay in their first job out of college for four years or less. [4] In the teaching profession, employee attrition is particularly acute, where it is estimated that nearly 40-50% of all new teachers leave the profession within the first five years. [5] However, outdated public pension systems originally designed to provide security for those who stay in a single profession for decades are now punishing this new crop of highly-mobile teachers and leaving them to fend for themselves.

The vast majority of states require their teachers to participate in traditional defined benefit pension plans. These plans guarantee long-term employees an annuity upon retirement, often calculated by a formula that takes into account years of service and highest salary. Teachers do not, however, qualify for minimum benefits until after a set vesting period, and then they must work on average an additional 20 to 25 years to receive their full retirement benefits. But with very few of today's teachers remaining in the classroom for 30-plus years, new data from Bellwether Education Partners indicates that less than 20% of beginning teachers will collect a full pension under these outdated rules, and less than half will collect even a minimum pension. [6] As a result, more than half of new teachers who begin the profession today will walk away from teaching with nothing to show for all the contributions their employer made to their retirement during their years in the classroom—in most cases, they will only be entitled to recoup their own employee contributions.

3. Teachers are unfairly penalized for moving across state lines.

A recent study found that teachers with 30 years of experience can lose anywhere from 40 to 75% of their total net pension wealth simply for crossing state (and in some cases district) lines. [7] This incompatibility between state and district pension systems forces all teachers—regardless of their tenure in the classroom—to start back at square one when they begin teaching in a new state. This means having to wait years to re-vest into a system that will deem you as having fewer years of experience and a lower final average salary, ultimately creating a less favorable formula for calculating your eventual pension payout. And while some states allow teachers to buy a few “pension credits” to attempt to make up for this loss, they are nowhere near sufficient to make teachers who move whole.

4. Over 40% of the teaching force is not enrolled in the Social Security system.

Today, teachers in 12 states (AK, CA, CO, CT, IL, KY, LA, ME, MA, NV, OH, TX) and the District of Columbia, who make up roughly 40% of teachers in this country, do not participate in Social Security. [8] Federal law requires that all employees not covered under Social Security must be enrolled in a retirement plan that provides a minimum retirement benefit. These guidelines, also known as the rules for “FICA replacement plans,” exist to ensure that employees who aren’t covered are guaranteed at least the same baseline retirement surety that Social Security affords.

Under FICA replacement plans, employees in a traditional defined benefit pension (including most teachers) are entitled to an annual benefit at least equal to 1.5% their average compensation during their last three years of employment, multiplied by their years of service. [9] For those who participate in a defined contribution plan, federal guidelines dictate that contributions from both the employer and employee must equal at least 7.5% of the employee's compensation annually. [10] But vesting requirements are not referenced at all in FICA replacement plan rules—meaning that states can increase them without calling into question whether doing so comports with the goal of ensuring their workers have at least as much retirement security as Social Security would provide.

5. There are no workable guidelines for replacing Social Security coverage with cash balance plans.

Some states are moving to more modern pension systems, but the federal government is not keeping up. One of the main ways states have begun to address the unsustainable and outdated nature of their teacher pension systems is to look closer at moving new employees into retirement plans that fall outside of the traditional defined benefit structure. One such kind of plan, known as a "cash balance plan," has gotten significant attention from states for its ability to bring in elements of both the security of a traditional defined benefit plan and the flexibility of a defined contribution plan in a way that will not bankrupt their current pension systems. Under a cash balance plan, teachers would have individual retirement accounts that would accrue at a guaranteed rate of return (usually some moderately conservative estimate, like 5%) rather than based on a complicated formula. That money would be managed by the state in a pool with other teachers' accounts. Once vested, this plan would make it much easier for teachers to take their own retirement accounts elsewhere—even across state lines if they changed jobs or moved. And at retirement, they would receive an account balance that could be taken either as a lump sum or as an annuity. [11]

Cash balance plans show significant promise in addressing the problems currently plaguing teacher pension systems. However, as more states look to consider adopting cash balance plans (or hybrids that combine multiple different kinds of retirement plans) for new teachers, the federal government is making that transition more difficult. The structure of a cash balance plan does not fall cleanly into the current FICA replacement plan rules for either a defined benefit or a defined contribution plan. Legally, cash balance plans would fall under the rules for a traditional defined benefit plan, as Internal Revenue Service (IRS) guidelines label a defined benefit plan as "any plan other than a defined contribution plan."[12] However, since cash balance plans do not automatically create an annuity, it is difficult to translate the current FICA replacement plan rules to ascertain whether cash balance systems should be deemed generous enough to cover those employees outside the Social Security system. As such, states are in jeopardy of not knowing whether they are violating federal law if they provide non-Social Security participating employees with cash balance plans—creating an unnecessary roadblock for states looking to modernize their pension systems for a new generation of workers.

The Solution

Create a FICA replacement plan for cash balance systems.

The Administration could take immediate steps to create FICA replacement rules for cash balance plans and other hybrid retirement systems, and to offer pre-approved plan options for each so that states don't have to wait for IRS approval. The rules could lay out clear guidelines for what a minimum benefit should look like in a cash balance plan, including guidance on the level of appropriate contributions, as well as a minimum level of guaranteed returns. Today, six states either have or are looking to implement a cash balance plan for their public sector employees, including for teachers in Kansas and Louisiana (pending).[13] And since teachers in many states do not participate in Social Security, states must be able to have confidence that their cash balance plans will be sufficient to replace that retirement safety net. And as additional states begin to seriously contemplate pension overhauls, a clear set of federal guidelines and pre-approved plans would give states the concrete federal assurance that cash balance plans are in fact a legitimate retirement option for their teachers—even those who aren't in Social Security.

Factor vesting times into FICA replacement plans.

With increasingly longer vesting times and higher mobility within and out of the teaching profession, the current FICA replacement plans are simply failing teachers who are outside of the Social Security system. Right now, the FICA replacement plan formula does not take into account how long a plan takes to vest in determining whether it is robust enough to take the place of Social Security. That means that a plan could be considered a sufficient replacement for Social Security even if it didn't allow a teacher to vest for two decades. As generous as some of these plans may be for those who stay in the profession for their entire career, they are currently only protecting 45% of the teacher workforce in non-Social Security states—leaving more than half without a dime of employer contribution to their retirement if they leave. [14] But the IRS could re-write the FICA replacement plan rules to better accommodate and protect this new majority of teachers. By factoring vesting times into the FICA replacement formula, we could gain a more fair assessment of how well a proposed plan is really standing in for Social Security and ensure a much more secure retirement for today's teachers.

Shorten the rules around vesting times for all teachers.

The inclusion of such vesting times into updated FICA replacement plans would better protect today's modern teaching workforce, but in order to ensure teachers across the country have similar protections already required for private sector employees, we need to create new federal guidelines that shorten the minimum vesting times for public sector employees. Today, states are only required to abide by pre-ERISA (pre-1974) IRS Code when determining the vesting times for their public sector employees. Within the IRS Code, two safe harbor vesting schedules detail what protections must be available for teachers: states must either offer a minimum 15-year cliff (all at once) vesting schedule or a 20-year graded (gradual over time) vesting schedule. [15] Updated vesting schedules that more closely align with the ERISA rules for non-public sector plans (closer to those 3 to 6 year vesting periods) would ensure that districts and schools aren't having to reduce teacher salaries by taking employer retirement contributions off the top that those same teachers will never again see.

Critiques & Responses

Cash balance plans are too risky for teacher retirement.

Unlike 401(k) plans where employees are responsible for managing their own retirement accounts and investment strategies, in cash balance plans, the employer is in charge of managing all investments. This also means that the employer ultimately bears the risk of such investments, since a minimum return is guaranteed to all participants. [16] In a cash balance system, teachers would never be left on their own at the mercy of the stock market.

Longer vesting times increase teacher retention.

Teacher retention is important, but using unreasonable vesting requirements that would be considered illegal in the private sector is not the way to retain talent. Further, there's no evidence it works. While studies have shown that teachers nearing the end of their careers will deliberately schedule their retirement to maximize their pension payout, no empirical evidence exists to show that those same considerations exist for early-and mid-career teachers looking to leave the classroom. In fact, when examining pension withdrawal tables, researchers have found that there is no notable difference in withdrawal rates for teachers leading up to and after the vesting mark—indicating that teachers with less than 10 years of experience do not make employment decisions with their retirement plans in mind.[17] As a result, states are purposefully increasing vesting times for financial reasons, knowing full well that many young people will help to fill state coffers by willingly leaving their own employer contributions behind.

Moving away from defined benefit plans and into cash balance plans will bankrupt states.

One of the benefits of transitioning to a cash balance plan instead of a traditional 401(k) is that a cash balance plan can be managed within a state's existing defined benefit structure—reducing or eliminating many of the transition costs. All new contributions in a cash balance plan would enter directly into the same pension fund that already exists, allowing cash flow to be uninterrupted for current and future retirees.[18] The new entrants would simply accrue benefits based on a different formula—one that is more linear and easily transferrable.

TOPICS

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END NOTES

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