
Public and Private Sector Compensation

**Presentation to the
Public Employees' and Retirees' Benefit
Sustainability Commission**

**Department of Legislative Services
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Overview

- Public vs. Private Employee Compensation
- Defined Benefit vs. Defined Contribution Plans
- Trends in Private Sector Retirement Benefits

Misused Data Prompt Misconception About Public Compensation

- As reflected in March 2010 *Employer Costs for Employee Compensation* report of the Bureau of Labor Statistics, the average hourly compensation is:
 - \$39.81 for public sector employees
 - \$27.73 for private sector employees
- Compensation gap reported by numerous mainstream media outlets despite the following stipulation within the published report:
 - “Compensation cost levels in State and local government should not be directly compared with levels in private industry. Differences between these sectors stem from factors such as variation in work activities and occupational structures. Manufacturing and sales, for example, make up a large part of private industry work activities but are rare in State and local government. Professional and administrative support occupations (including teachers) account for two-thirds of the State and local government workforce, compared with one-half of private industry.”

Apples and Apples?

- One-quarter of 509 job classifications used by the U.S. Census are unique to either the public or private sectors
- Over the past 25 years, government workers have been older, better educated, and more likely to be covered by a union contract

Key Characteristics of Private and Public Sector Government Employees 1983-2008

	<u>Private Sector</u>	<u>State Government</u>	<u>Local Government</u>
Age	37.4	41.6	41.7
College Degree	16.0%	23.0%	23.2%
Post-College	6.6%	25.1%	24.7%
Union Contract	13.0%	38.4%	52.3%

Source: Current Population Survey, as cited in *Out of Balance?*, 2010.

All Things Being Equal....

- State government employees are paid less than similar private sector employees
 - 11% pay gap between State and private employees, according to the National Institute on Retirement Security (NIRS) study
 - 19% pay gap according to the Economic Policy Institute (EPI) study
- Pay gap is smaller between local government and private sector employees

Public Sector Offers Better Benefits

- Total benefits are 34% of total compensation for public sector employees, compared with 26 - 33% in the private sector, depending on employer size
- Large private firms (500+ employees) offer more paid leave and supplemental pay than State and local governments but contribute less toward health insurance and retirement benefits
- **Including pay and benefits, State government employees earn 6.8% less than private sector counterparts (according to NIRS) and 10.7% less (according to EPI)**

Critiques of Compensation Studies

- Do not challenge general finding that public sector employees are paid less than private sector counterparts
- Value of public employer benefits is understated due to prevalence of unfunded liabilities
- Value of civil service and union protections, such as job security, are not included in the analysis

Defined Benefit vs. Defined Contribution

Defined Benefit (DB) Plans

- **Purpose:** To provide a guaranteed postretirement annuity for the remainder of a retiree's (or beneficiary's) life
- **Benefit:** Annuity determined by employee's final average compensation, years of service, and benefit multiplier designed to provide a specific level of income replacement
- **Funding:** Actuarially funded in shared risk pool, with assets provided by employer and/or employee contributions and investment returns

Defined Contribution (DC) Plans

- **Purpose:** To provide a vehicle for individual tax-deferred retirement savings in an employer-sponsored plan
- **Benefit:** Account balance at the time of an individual's retirement, payable as a lump sum, periodic distributions, or annuity
- **Funding:** Employer and/or employee contributions and investment returns held in individual accounts

DB and DC Both Have Advantages and Disadvantages

	Defined Benefit	Defined Contribution
Eligibility	Condition of employment	Optional participation
Longevity Risk Pool	Shared	Individual
Investment risk	Assumed by plan sponsor	Assumed by employee
Employer contribution	Yes	Optional; often in the form of an employer match
Employee contribution	At employer's discretion	At employee's discretion
Tax deferred?	Federal only (MD)	State and federal
Portability	Limited or none	Yes

DB More Cost Effective Than DC

- According to a study by NIRS, the cost of providing the same retirement benefit is 46.0% lower for DB plans than for DC plans because DB plans offer:
 - Shared risk pools (15.0% savings)
 - Long-term portfolio diversification (5.0% savings)
 - Superior investment returns (26.0% savings)
 - Access to wider array of asset classes
- Most research concludes that investment returns for DB plans are 0.8 - 1.2% (80 to 120 basis points) higher than DC plans, and DB plans pay lower asset management fees

Risks of DC Plans

- Individuals do not save enough for retirement
 - June 2010 American Association of Retired Persons survey of adults age 45 - 64
 - 54% never calculated how much they need to save for retirement
 - 48% had less than \$50,000 in retirement savings
 - 28% had stopped contributing to DC plans within the last six months
 - 16% had prematurely withdrawn funds from DC plans
- Potential strain on social safety net

Risks of DB Plans

- Public employers do not fully fund their plans
 - Pew Center 2007 and 2010 studies
 - From fiscal 1996 to 2006, about one-third of states chose to pay less than the required employer contributions
 - Between fiscal 2006 and 2008, unfunded liabilities in State DB plans grew by \$236 billion across 50 states
- Aggregate funding ratios for corporate DB plans fell in one year from 107.9% in 2007 to 80.6% in 2008
- Cost of baby boomers' retirement is being shifted to future generations

Public Employees Choose DB

- In the last 10 years, seven state pension plans have given new members a choice between a DB plan or a DC plan.

	<u>DB by Default or Active Choice</u>	<u>DC Active Choice</u>
Colorado	82%	18%
Florida	74%	26%
Montana	90%	10%
North Dakota	88%	12%
Ohio Employees	95%	3%
Ohio Teachers	85%	11%
South Carolina	80%	20%

Note: Two percent of Ohio employees and 4% of Ohio teachers opted for a combined plan, which was not offered in other states.

Source: Milliman

DC Plans for Maryland Public Employees

- Optional Retirement Program (ORP)
 - Eligible employees include:
 - Faculty members of public institutions of higher education in the State (including community colleges)
 - Professional employees of community colleges
 - Professional or administrative staff at Morgan State University and St. Mary's College of Maryland
- Teachers' and State Employees' Supplemental Retirement Plans
 - Offers supplemental 401(k), 403(b), and 457 plans to State employees and employees of State institutions of higher education

Optional Retirement Program

- One-time, irrevocable decision to participate in the ORP in lieu of participating in a State DB plan; must be made within one year of hiring
- Employer contribution of 7.25% of compensation; employee contributions are not allowed
- Two program vendors (TIAA-CREF and Fidelity) offer several dozen investment vehicles, including life cycle funds
- 35,364 member accounts as of June 30, 2009; no data is available on take-up rate
- Limited and divided State oversight of the ORP

Maryland Supplemental Plans

- 61,202 participants as of June 30, 2009; 72% participation rate
- 40,692 actively contributing to their accounts, or 66% of participants and 48% of eligible employees
- Employer match program for regular State employees
 - Statutory cap of \$600 for employer match
 - Match suspended in fiscal 2004, 2005, 2010, and 2011; capped at \$400 for fiscal 2006

The New Generation: Hybrid Plans

- Hybrid retirement plans combine elements of both DB and DC plans
- Two basic models of hybrid plans:
 - Combined DB/DC plans (public sector)
 - Cash balance plans (private sector)

Combined DB/DC Plans

- Federal Employees' Retirement System (1987)
 - Basic Benefit Plan
 - DB component
 - 6% employee contribution
 - 1% multiplier (1.1% if retire after age 62 with 20 years)
 - Thrift Savings Plan
 - DC component
 - 1% automatic employer contribution
 - 100% employer match up to 3% of pay; 50% match between 3% and 5% of pay
- Indiana, Washington, Oregon, and Georgia offer combined plans

Cash Balance Plans

- Most common in private sector
- First plan adopted in 1985; legal issues slowed rate of conversion of DB plans.
- Features of DC plans
 - “Virtual” individual accounts
 - Fixed employer contributions
 - Benefit consists of asset value in the individual account at the time of retirement
 - Portable
- Features of DB plans
 - Guaranteed benefit (rate of return)
 - Pooled assets centrally managed
 - Investment risk borne by employer

Trends in Private Sector Retirement Benefits

DB Plans More Scarce in Private Sector

- Number of private sector DB plans has dropped from 148,096 in 1980 to 48,982 in 2009
- Percentage of private sector workforce with access to a DB plan has been cut almost in half, from 38% in 1980 to 21% in 2009
- By contrast, in 2009, 84% of public sector workers had access to a defined benefit pension option

Participation in DC Plans Is Weak

Sector	DB Provided by Employer	Employee Take-up	DC Provided by Employer	Employee Take-up
Private	21%	93%	61%	70%
Public	84%	94%	30%	58%

- 2009 participation rates in DB plans is comparable in the public and private sector (93% in the private sector and 94% in the public sector) due to mandatory participation for most plans
- In 2009, private sector employees were more likely than public sector employees to participate in a DC plan when it was offered (70% of private sector employees compared with 58% of public sector employees)

DC Plans Are Scaling Back Benefits...Because They Can

- In the year following the financial crisis (September 2008 to September 2009), Internal Revenue Service data indicates that more workers lost DC benefits than DB pension access
 - 263,616 workers lost access to a DB plan
 - 595,521 lost access to a DC plan
- One in five United States companies with at least 1,000 workers have reduced or suspended their matching contributions since September 2008
- Roughly half have yet to restore those benefits, though many are considering reinstating at least a portion of the match within the next 12 months (according to Towers Watson survey)