Maine Squeeze

By Joseph A. Tomlinson, CFP *Mon, Sep 27, 2010*

By merging its pension plan with Social Security, Maine could offer its public employees a more equitable deal. But can the state's budget handle the potentially higher costs?

Maine is one of 14 states whose teachers, firefighters, police officers, forest rangers, game wardens, and snowplow crews earn state pensions instead of participating in Social Security. But some of the lawmakers up in Augusta want to change that.

They propose that newly hired state employees participate in a hybrid pension consisting of Social Security and a reduced form of the current state pension. These lawmakers worry about the inequity of the current system: Like most defined benefit plans, it rewards long-service employees but does not provide adequate benefits or portability for those with shorter service.

A merger with Social Security would make the system fairer. But it would also increase pension costs at a time when Maine has a big unfunded pension liability. Its shortfall totals about $4.5 billion, or about one-third of the total pension liability. For many other states the situation is much worse; nationwide, the states' unfunded liability is about $1 trillion.

Maine follows strict actuarial standards and has been paying down its liability, but the financial crisis created an especially tight fiscal environment. Any proposal that might increase pension costs would likely meet political resistance.

You may have read or heard about Maine's pension problems. Unfortunately, much of the reporting on this topic has been off-target or just plain wrong. Headlines like, "Maine eyes Social Security for Pension Bailout," are misleading. Maine's interest in Social Security arises from its desire for a fairer system, not from its need to solve an unfunded liability problem.

One might question the wisdom of placing new state employees under Social Security, given the concerns about the federal program's future. Some might even regard Maine's interest in Social Security as "seeking rescue on a leaky lobster boat." But the story is more complex than that.

The Maine Pension System

Maine's existing defined-benefit offers 2% of final-average-pay for each year of service, plus annual cost-of-living adjustments, or COLAs. The standard retirement age for an unreduced pension is 62. Employees contribute 7.65% of pay, and those who work for 40 years can retire on close to 80% of their final salaries. But only 20% of employees earn 25 or more years of benefits, and just 50% fulfill the five-year vesting period. Many employees who leave the system before retiring opt out of it. They can withdraw their personal contributions—but forfeit any contributions by the state.

Because the system provides so little for most employees, the state can fully fund the plan with current contributions of only about 5.5% of payroll. These contributions may fluctuate depending on the plan's experience.

State Senator Peter Mills, the strongest advocate for bringing in Social Security, has described the current system as "immoral." "It takes younger people and feeds off them," he said. "You can withdraw from teaching at age 40 and realize you've got nothing to look ahead to for your old age."

By "backloading" payouts, many state and local pension plans encourage long tenures, discourage mobility and motivate participants to creatively boost income during their final years. Since teachers can earn extra pay by coaching sports, for example, you'll often see elderly coaches warming the benches at high school sports events.

Adding Social Security to a state pension plan would reduce backloading, because the Social Security portion of the retirement program is based on inflation-adjusted career average earnings, not on final pay. Putting Maine state employees under Social Security, as most states do, would provide a more portable pension for shorter-service employees. With workers changing jobs more frequently today than a generation ago, portability is increasingly important.

Solving the Problem

In 2009, the Maine legislature created a task force to study ways to combine its pension with Social Security. To include all existing employees in such a revamped system would be financially and logistically impractical, so the task force focused on future hires. The task force included pension system stakeholders, consulting actuaries, and Sandy Matheson, the then-new director of the Maine Public Employees Retirement System (MainePERS). Matheson came from Washington State, where she had worked in both executive management and benefits management.

The team ruled out a defined contribution option, saying that DC plans typically "do not adequately assist individuals with retirement readiness or act as a retention incentive." They did not recommend a specific defined benefit option, leaving the state legislature to weigh alternatives.

One of the defined benefit options would combine Social Security with a DB pension with an annual accrual rate of only 1% instead of 2%. This plan would also require the state and the employees to each pay about 9% of income, with each paying 6.2% to Social Security. Such a plan would raise payouts for shorter service employees, lower payouts for longer-service employees, and raise replacement rates for lower-paid workers.

With total costs of around 18% of payroll, such a plan would cost four to five percentage points more than the current plan. The higher costs would only apply to new hires, and the added expense would phase in over time.

A question worth considering is whether Maine could provide the same benefit structure without merging with Social Security. What if all contributions were kept in-state and invested in risky assets? (This argument will be familiar to those who remember Social Security "privatization.")

Indeed, the state might be able to earn a higher return than Social Security. Technically, the current state pension plan has an assumed rate of return of 7.75%. The real rate of return of a national pay-as-you-go pension system like Social Security roughly equals the real growth rate of national income. Social Security actuaries expect a real growth rate of 3% in the near term, declining to 2.1% after 2050. If we assume an inflation rate of 2%, that's a nominal Social Security return of 4% to 5%, well below the assumed nominal 7.75% rate for the state pension plan.

But this is not an apples-to-apples comparison. The state pension plan invests 75% of its assets in equities, which are much riskier than the special Treasury bonds that Social Security buys. Indeed, a major benefit from splicing the state pension onto Social Security would be risk reduction.

Integration with Social Security offers additional benefits as well. It would facilitate mobility between private sector and public sector jobs, because the state's contributions to Social Security would be fully portable. It would eliminate the impact of Social Security's Windfall Elimination Provision and Government Pension Offset on individuals who spend part of their working lives outside Social Security, and help couples optimize Social Security benefits through coordinated claiming strategies. Social Security also provides ancillary benefits for spouses, surviving family members, and for disability.

Prospects for reform

Social Security faces its own set of problems, however, such as the immensity of the Baby Boomer cohort relative to the number of active workers and rising longevity. Sixty percent of working adults don't believe they'll collect Social Security at all, according to a recent USA Today/Gallup poll.

But the situation may not be so dire. The Center for Retirement Research at Boston College recently calculated that a payroll tax hike to 14.4% from the current 12.4% (combined employer and employee contributions) would keep the system solvent for 75 more years.

It's hard to assess the prospects for integrating Social Security into Maine's pension. This is an election year, and many new faces, including a new governor, will be in Augusta come January 2011. The new government will have to write a budget for fiscal 2012-2013, and that means dealing with the unfunded pension liability. Even though the additional costs of merging the current pension system with Social Security would be phased in gradually, it will still be difficult to build support for any reforms that raise costs, regardless of the merits.

My prediction: Maine will eventually bring Social Security into its pension system, but not for several years. On the other hand, the people of Maine have a tradition of doing what's right, even when it's not easy. So change may occur sooner rather than later.

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