Public Sector Pensions in Nebraska:
Are Cash Balance Plans the Answer?
By Andrew G. Biggs

Yesterday, the Platte Institute released its policy study on public sector pensions, examining the benefits and shortcomings of Nebraska's unique cash-balance plan.

The cash-balance plan (CB) presents what could be a model for public sector pension reform, as CBs offer some of the better aspects of both traditional defined benefit pensions (DB)-the most common public sector pension-and defined contribution plans (DC)-401(k)-type plans that dominate in the private sector and where participants bear the investment risk. CBs offer far greater portability than DB pensions, allowing public employers to attract young mobile employees and removing disincentives for employees to leave.

However, CB and DB plans both operate under a set of accounting rules that economists almost universally believe understates pension liabilities and hides investment risks borne by taxpayers. In the case of Nebraska's cash balance plans, this arises through the government's guarantee of a 5 percent annual return on account balances regardless of the returns available in the market. Such a guarantee is easily priced and shows the true costs of the Nebraska cash balance plan to be far greater than currently understood.

While the cash balance plan claims to be 95 percent funded, when the market value of the rate of return guarantee is included, the plan is only around 50 percent funded. Claims by pension managers that market values do not apply to government plans are not supported by the vast majority of economists; to dismiss market evaluations imperils taxpayer money.

CB plans also allow greater financial transparency than DB plans by making their rate of return guarantees explicit and easier to understand. Yet they are still not the most transparent system; DC plans are by far the most transparent and the least susceptible to gaming by employees and policymakers alike. Furthermore, when DC plans are set up as thrift savings plans, they become even more beneficial for both recipients and taxpayers, as they allow retiring workers to easily and inexpensively convert a lump sum into a lifetime income.

While Nebraska is in better shape than most states, there is still work to be done. Nebraska's CB plans are innovative and could be a model for other states to follow as they try and bring their budgets and pensions under control. Yet there are other, more transparent and taxpayer-friendly ways Nebraska could construct the pension system. But for the time being, cash balance plans are putting Nebraska in a very good position relative to other states.

The full policy study may be viewed here.

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