Client Articles

The Growing Public Sector Pension Gap

Description

Gone are the days when a public sector pension guaranteed a comfortable lifetime retirement. Like their private sector counterparts, today's public employees need to plan and save.

Stories abound about the fireman who retires at age 45 with a six-figure pension, or the city manager who leaves after just five years' service with full salary and health coverage for life.

What doesn't make headlines, however, is the growing number of public sector employees who have seen their retirement benefits erode in the face of budget cutbacks and mounting public deficits. States and cities across the country are taking steps to reduce pension costs by whittling away employees' retirement entitlements. Even San Francisco, bastion of liberal handouts, recently saw voters approve a plan to scale back retirement benefits for city employees.

Although traditional pensions still dominate at all levels of state and local government, hybrid plans are emerging that combine a 401(k)-type component with a guaranteed benefit. In fact, 11 states -- including Alaska, Michigan, Colorado, Florida, and Ohio, plus Washington, D.C. -- now have primary retirement plans that include some defined contribution component.[1]

The upshot for public sector employees is that, increasingly, they are likely to need to augment their pensions with salary contributions to employer-sponsored plans or save on their own if they want to maintain their preretirement lifestyle. And since many states have "double dipping" laws in place that prevent public employees from collecting both Social Security and a state pension, the need to set aside their own funds for retirement is even more important.

How to Compensate

Several tax-advantaged retirement savings options exist that may be accessible to public sector employees. The most popular include:

- 403(b) plans are generally available to employees of qualified public organizations such as schools, hospitals, and certain nonprofit employers. Similar to 401(k) plans, 403(b) plans allow employees to contribute a portion of their salary on a pre-tax basis; and no tax is paid on contributions or earnings until it is withdrawn in retirement.[2]
- 457 plans are available to state and local government employees and are somewhat similar to 403(b) plans. There is no penalty for early distributions from a 457 plan (however, taxes are due), although you generally cannot take in-service distributions unless you have an unforeseen emergency.
- IRAs are available to both public and private sector employees. Like 403(b) and 457 plans, IRAs also offer tax-deductible contributions and tax deferral. However, IRAs have lower annual contribution limits and eligibility for favorable tax treatment may be subject to certain income limits.2

To find more information on these or other tax-advantaged retirement savings plans, see Publication 590 at http://www.irs.gov/.

Source/Disclaimer:

[1]Source: Journal of Pension Economics and Finance, "Behavioral Economics Perspectives on Public Sector Pension Plans," April 2011.

[2]Withdrawals from 403(b) plans and IRAs prior to age 59½ may also be subject to a 10% early withdrawal penalty, in addition to ordinary tax on withdrawn amounts.

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