



The Common Thread

What's woven into the most successful state retirement plans?

Here's what our new nationwide analysis shows



In the not too distant past.

most public servants and teachers could expect a lifelong career in a single state or local government, followed by a pension guaranteed to replace 50-60% of their final earnings.¹ But as anyone who's lived it knows, public sector employment has changed dramatically over the last 20 years. Workers are more mobile. State employers have expanded the retirement plan landscape to include models beyond the traditional defined benefit (DB) pension. Employees now have many more options when deciding the best way to save for retirement.

What hasn't changed is what state employers have long known: retirees need predictable income they can count on, because income—more so than mere asset accumulation—is what really determines quality of life after careers end. And when today's 67-year-old has a

25% chance of living to 95,² that income has to last longer and longer.

As public sector retirement plans evolve, then, the question isn't whether more guaranteed income replacement is needed, but how to achieve it.

50 states, 85 systems (and one Social Security) later

Earlier this year, the National Council of Insurance Legislators formally called on states to review their retirement plan offerings to ensure they provide adequate lifetime income. New TIAA Institute research examining 85 major systems from every state did just that, assessing their ability to hit the industry's key benchmark: replacing 80% of pre-retirement income

We found a diverse array of paths to 80%, along with the specific interventions that can boost plans with lower replacement rates over the hump. The systems we investigated fall into four primary plan designs:

- **DB plans** remain the most common and are still the primary source of guaranteed income in more than 35 states. But as we'll see, not all DB plans are created equal.
- **Hybrid plans** are now available in a dozen states. They reduce reliance on their DB component by supplementing with a mandatory defined contribution (DC) element.
- **Cash Balance plans**, offered by only four states, present an employer-funded guaranteed benefit as an account balance converted into lifetime income at retirement.
- **DC plans** are now offered in 13 states; they are the primary plan in four states. These plans are the norm in the private sector, with both employer and employee contributing. Employees can opt for the employer's default investment solution (more than half do), or choose their investments from an employer-determined menu.

Each of these models—and the myriad levers within them—present distinct opportunities to ensure adequate income and retirement security. But no lever competes on the scale of Social Security. In its early years, public employees were expressly excluded from Social Security. After a slow shift toward states' permission to participate in the 1950s, Social Security is now a common component of public sector retirement income. It's far from universal, though, and its shoes are very hard to fill. For participants in the 20% of plans that don't include it, running short of money in retirement is a real risk.

What's in a number?

Why we believe 80% is the right income replacement target

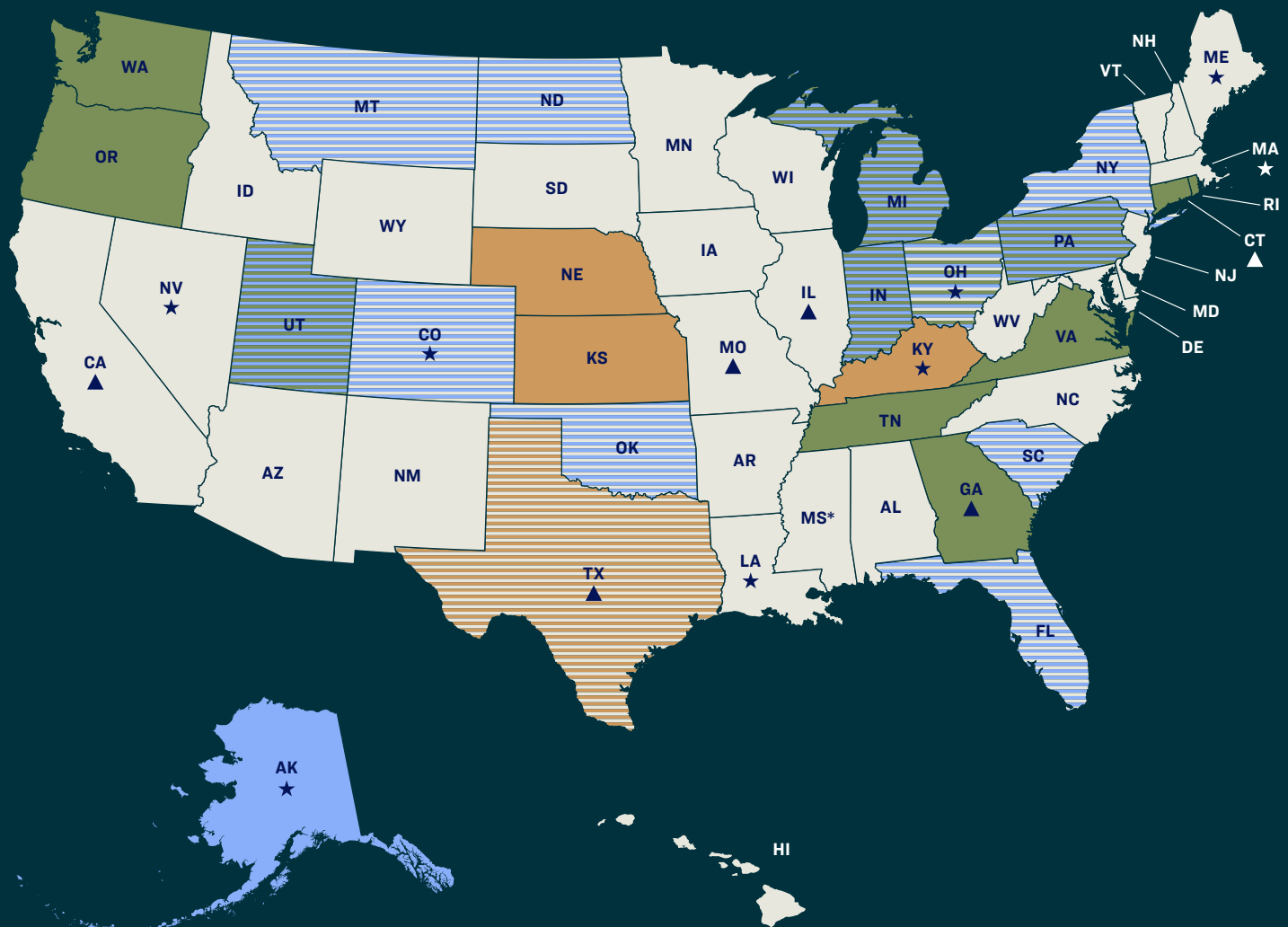
Imagining an overnight 20% pay cut during your working years might cause your heart to skip a beat. But the reality is that retirements—even full, comfortable ones—are likely to come with at least some reduction in out-of-pocket expenses. Historically, that led to a now common benchmark in financial planning: aiming to replace 80% of pre-retirement income.

So what aren't retirees spending on? For starters, they have no FICA taxes (7.65% of pay) or retirement plan contributions (another 10-15% of pay). Employment-related costs—think commuting, unreimbursed expenses or the daily spending attached to having a career—also decline. And while not all public sector employees participate in Social Security or contribute 10% to retirement savings, others no longer have major expenses like mortgage payments, childcare or education costs.

Taking all that variability into account, we believe an 80% replacement rate is a reliable yardstick for measuring whether a plan is poised to deliver a consistent standard of living and a confident retirement.



The 50 states of retirement



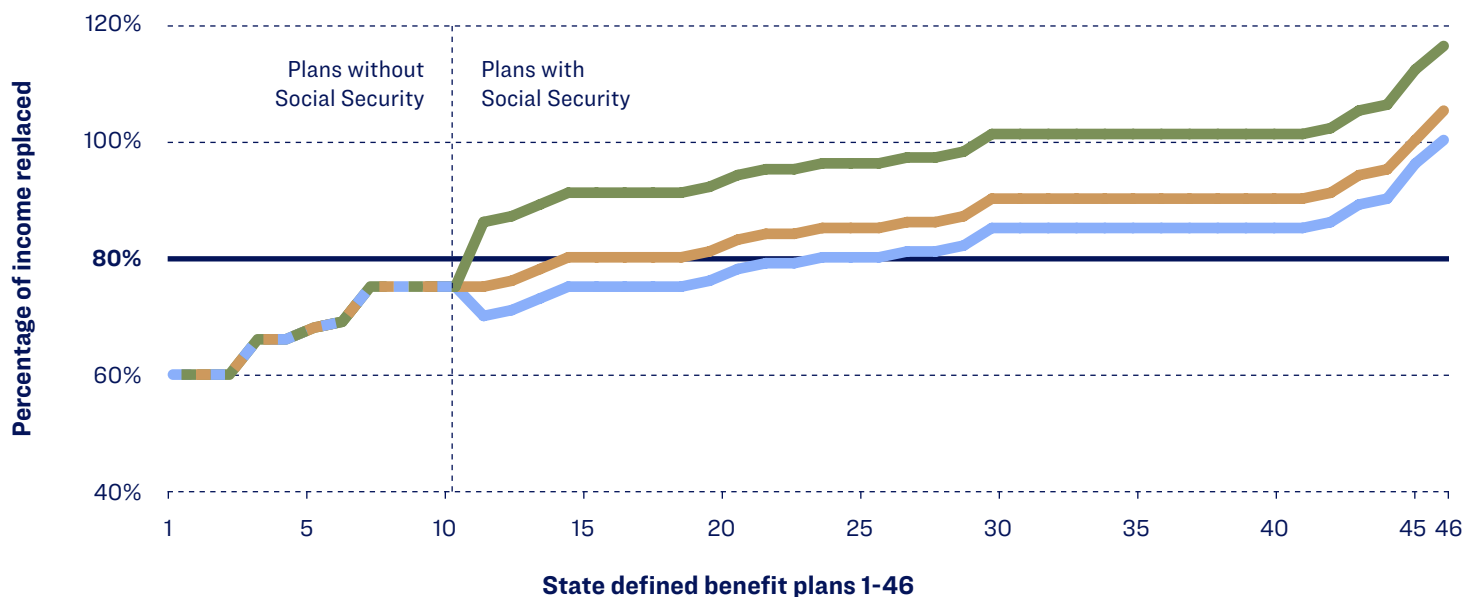
States indicated with a star (★) do not include Social Security.

States indicated with a triangle (▲) exclude Social Security only for the plan covering teachers.

* Mississippi has established a hybrid plan but it is not yet active.

- DB plan
- Hybrid plan
- Cash balance plan
- DC plan

Income replacement in defined benefit plans



Without Social Security, no DB plan reaches our 80% income replacement target. When Social Security is included, nearly all low earners' needs are met, but fewer plans reach 80% for high earners.

- Low Earners
- Median Earners
- High Earners

Defining the defined benefit

A retiree's DB pension is typically determined by three numbers: years of service, final salary, and the benefit multiplier—the percentage set by the employer that applies to everyone. (For example, with a 2% multiplier and 30 years of service, the DB plan will replace $2\% \times 30$, or 60% of pay.)

It seems simple, but it's a true case of the devil being in the details. Small changes in any one of the three factors can result in big income differences. Average the highest 10 years of earnings instead of the highest three and your "final" salary shrinks quickly. Reduce the benefit multiplier by a single percentage point and we found your replaced income could drop from 75% to 48%.

Without Social Security, no DB plan reaches our 80% income replacement target. The best option for the employers and policymakers looking to fortify these systems? Auto-enrolling employees into a supplemental deferred compensation savings plan—a 457 plan—that comes with the access to lifetime income Social Security would otherwise provide.

For plans with Social Security, the story is both rosier and more complicated. While nearly all Social Security-including plans will meet (or even exceed) the needs of low earners, only a third will provide sufficient income for the high earners who see less replacement from Social Security. The good news is that these higher earners are well positioned to make the most of a supplemental savings plan. And no matter how much employees earn,

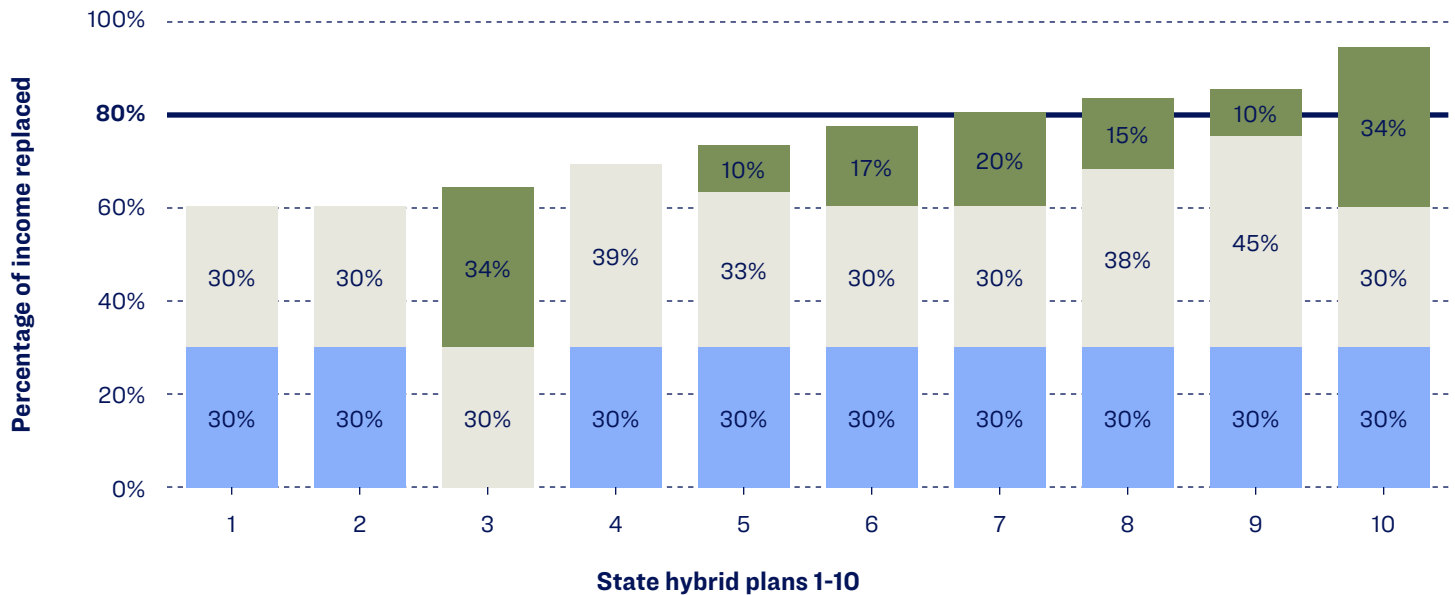
supplemental plans can help them treat Social Security as an asset class to be maximized. With a bridge strategy that provides income at 62, they can retire without claiming Social Security benefits until those benefits are at or near peak.

Going hybrid

The strongest hybrids can be the club sandwiches of retirement plans, offering triple-decker access to lifetime income through their DB component, DC component and Social Security. These best-practice designs generally provide 80% income replacement to median and low earners even if they don't annuitize all their DC savings.

But when hybrid plans forgo one of the three guaranteed income generators, they fall very short. Meeting the goal of their design—to accommodate lower

Income replacement in hybrid plans



To meet our 80% income replacement target, hybrid plans need three sources of guaranteed lifetime income.

- Social Security
- Defined Benefit
- Defined Contribution annuity

defined benefit multipliers thanks to a DC component—requires that DC component to include lifetime income.

Cash balance (CB) plans guarantee minimum returns on employer contributions while offering the potential for higher returns up to a cap. Usually set to 4%, these minimums are indeed minimal, and aren't sufficient to replace income even with the assist of Social Security. Three of the four CB plans in our research do meet the income bar if we assume they consistently credit above their guaranteed floors to achieve growth closer to 7% than 4%. For a secure retirement, they also must have a combined employer-employee contribution rate of at least 12%.

Defined contributions

Like all retirement plans, DC systems come with tradeoffs. They provide state

employers budget predictability and offer employees a flexible benefit that can move with them as their careers progress. But achieving sufficient income replacement with a DC plan depends on a number of aligned factors: adequate employer-employee contributions, a diversified risk-appropriate portfolio, and importantly, the availability of in-plan lifetime income options.

In fact, we found that the common rule of thumb for spending in retirement— withdrawing 4% of savings a year—can't provide a DC participant 80% income replacement on its own. But even partially annuitizing a lifetime income investment significantly increases the likelihood of adequate income. It's also easier for retirees, simplifying their income strategy by easing the burden of balancing income on the one hand and preserving sufficient principal on the other.

What's next

Between whiplash-inducing technological change and political, cultural and market uncertainty, none of us can be sure that what used to work will continue to work. It's as true for the traditional DB system as it is the people who bring government to life every day.

As the number of hybrid and even DC-only options available to state workers keeps expanding, the need for lifetime income access grows too. Our task now is to ensure it's available in multiple forms, in every state, for every worker.

Getting to target income replacement: What it takes

Defined Benefit plans	Don't include Social Security	+	Include access to lifetime income in supplemental DC savings plans			
	Include Social Security	+	Use a benefit multiplier of at least 1.6%			
Hybrid plans		+	Include access to lifetime income in the DC portion of the plan	+	Have a combined employee-employer contribution rate of at least 6%	
		Cash Balance plans	+	Provide returns above the required minimum	+	Have a combined employee-employer contribution rate of 12%
			Defined Contribution plans	+	Include access to lifetime income	+

Our analysis assumes 30 years of service. For DC plans not paired with Social Security, combined employer-employee contribution rates would need to be substantially higher—at least 14% for those in hybrid plans and at least 22% for DC plans alone.



tiaa.org/tmrw

¹ A History of Public Sector Pensions in the United States, University of Pennsylvania Press, 2003.

² TIAA Institute, 2023.

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