Retirement Benefits in the Public Sector

Kern L. Watson

Virginia Tech

Abstract

Retirement benefits have historically been one of the most attractive aspects of public employment. Defined benefit plans are offered to 86 percent of state and local workers, with 89 percent of eligible workers taking advantage of such plans. By comparison, under half of eligible state and local government workers take part in defined contribution plans. (U.S. Bureau of Labor Statistics, 2015). Economic factors are making the public retirement benefit a point of discussion in many state and local governments. This paper provides a brief history and comparison between private and public retirement benefits, discusses the root causes leading to today's massive retirement problem, and discusses potential changes that will impact employees and administrators in the future.

Retirement Benefits in the Public Sector

Introduction

Retirement benefits are a staple of public employment. In the past decade there has been a major rethinking of the retirement benefit, often one of the most lucrative yet costly components of an employee's benefit package. Much of the responsibility for retirement planning has shifted from the company to the individual employee in the private sector, yet the public sector has been slow to make a similar change. As states and localities try to survive tough economic times, the retirement benefit has taken center stage in many discussion. Previously considered a secure and largely untouchable benefit, the defined benefit pension is coming under increased scrutiny. Privatization and benefit reductions are among the changes facing public administrators, who manage benefits for both those already receiving retirement benefits and those employees entering public sector employment.

Background

In state and local government, over 90 percent of employees have access to some form of retirement benefit. 89 percent of those with access to a benefit participate. These numbers are far higher than in the private sector, where only 66 percent of employees have access to a retirement benefit and fewer than half of those with access participate. (U.S. Bureau of Labor Statistics, 2015). In all, there are over 2670 retirement systems covering over 14 million state and local government employees, and an additional six million retirees. (Hess, 2005, p. 188). The importance and attractiveness of the public sector retirement benefit is even more understandable when one starts to look at the actual benefits available to employees. Retirement plans are broadly categorized into two segments, the defined benefit plan and the defined contribution plan.

Defined Benefit Plans

Defined benefit plans have been the cornerstone of the public-sector retirement benefit since the 1940's. (Employment Benefit Research Institute, 1998). Under a defined benefit plan, employees receive a specific benefit upon retirement, often an established percentage of that employee's salary. (Battaglio, Jr., 2015, p. 173). The governmental entity is the primary contributor to the retirement fund, on the employee's behalf. Employees often contribute as well, usually a small percentage of each paycheck. Contribution and retirement formulas are complex and vary by retirement system. In Miami, Florida firefighters and police officers earn 80 percent of their highest years' salary if they retire after 25 years of service. These employees contribute ten percent of earnings in addition to the municipality's contributions (Bauerlein, 2014). With defined benefit plans, funds are managed by a board or other independent entity, often at the local, state or regional level. The infrastructure to manage these funds is both complex and expensive to maintain, and suspect to political manipulation and corruption. (Hess, 2005, p. 195), (Raijnes, 2001).

Nearly 84 percent of all state and local government employees are eligible to participate in a defined benefit plan. (U.S. Bureau of Labor Statistics, 2015). This is in sharp contrast to private sector employees, only eighteen percent of whom have access to defined benefit plans. This represents a significant change for the private worker since 1970, when 45 percent of all private workers were participating in defined benefit plans. (Employment Benefit Research Institute, 1998). One notable exception to the decline of defined benefit plans in the private sector lies with the unionized employee; 72 percent of all union employees have access to a defined benefit plan. When unionized employees are removed from the data set, the number of private industry employees with access to defined benefit pensions drops to thirteen percent. (U.S. Bureau of Labor Statistics, 2015).

Defined Contribution Plans

Defined contribution plans became a serious option after the establishment of simplified employee pensions (SEP's), commonly referred to by their Internal Revenue Service designation 401(k). (Employment Benefit Research Institute, 1998). Defined contribution plans, as their name implies, are based upon the employer making a specific contribution, usually a percentage of the employee's income, to a retirement investment account. Employees are also typically required to contribute a portion of earnings to the account, often on a pre-tax basis up to certain limits established by the Internal Revenue Service. (U.S. Bureau of Labor Statistics, 2015). Unlike a defined benefit plan, the individual employee has some control over how the funds are invested. The benefit at retirement is based solely upon the amount invested and the investment return, and no specific benefit is guaranteed beyond that. Another key difference lies in the use of external firms to manage the funds, thus reducing the risk and expense associated with the retirement benefit. (Raijnes, 2001).

Defined contribution plans are the prevalent form of retirement benefit in private industry today. Over 90 percent of the plans available in private industry are defined contribution plans, with 68 percent requiring employee contributions as a condition of participation. In the state and local government setting, nearly one-third of employees have access to a defined contribution program. In state and local governments, these defined contribution plans are typically offered in addition to or as an option for the defined benefit plans. (U.S. Bureau of Labor Statistics, 2015), (Virginia Retirement System, 2014).

The Employee Perspective

There are many valid positive and negative points about each type of plan, and many relate directly to the employer-employee relationship. Retirement is a highly personal, emotional issue for employees. (Bauerlein, 2014). Defined benefit plans:

- Are more attractive to older, longer-tenured employees;
- Have a scalable architecture, based on tenure and earnings;
- Shield the employee from market fluctuations;
- Are almost exclusively within the control of the employer;
- Provide a tax benefit to the employer; and
- Are less portable between employers. (Raijnes, 2001).

Defined contribution plans:

- Tend to be more attractive to younger, less-tenured employees;
- Grant control of their retirement almost exclusively to the employee;
- Have a potentially higher return, if the employee takes investment risk;
- Lower the cost and risk of providing a retirement benefit;
- Provide tax benefits to both the employer and employee; and
- Are generally portable between employers, with quicker vesting of funds. (Raijnes, 2001).

Although the number of private workers covered by a retirement plan has remained constant over the past forty years at around forty million workers, the private sector was quick to transition from defined benefit to defined contribution plans. (Raijnes, 2001). The primary reasons for the private sector transition is directly reflected in the challenges facing the public sector as it continues to provide defined benefit plans.

The Challenges of Public Retirement Programs

There are three basic challenges that have combined to create major problems for the defined benefit retirement plans that make up the majority of retirement benefits for public employees. First, the retirement programs have not been funded using sound fiscal practices. (Beermann, 2013, p. 5). Second, especially with public safety personnel, retirement while younger than the private sector creates very long-term pension obligations. (Bauerlein, 2014). Third, by placing fund management within the government apparatus the door is opened to manipulation, mismanagement and corruption. (Hess, 2005, pp. 195-197). There are differing opinions on the extent of the crisis, although recent bankruptcy by Detroit, Michigan brought the issue into the national spotlight. Beermann states “The problem is likely to continue to grow with more municipalities finding it necessary to explore the bankruptcy option.” (2014, p. 999). With trillions of public dollars at stake, these challenges will not simply disappear. (Beermann, 2013, p. 12).

Fund Insolvency

In order for an individual employee to receive a retirement benefit, somewhere along the career path funds must be set aside. In the private sector, an employer’s pension fund is guaranteed under the Employee Retirement and Income Security Act of 1974 (ERISA). This act established the Pension Benefit Guaranty Corporation (PBGC), which serves the pension-program equivalent function of the Federal Depositor Insurance Corporation, which insures bank funds. The PBGC provides relief when an employer cannot meet pension obligations or goes out of business. Under ERISA, a plan sponsor is required to provide adequate funding of the plan to meet obligations, requires accountability and oversight, and guarantees pension benefits. (U.S. Department of Labor, 2015), (Beermann, 2013, p. 6). These same protections do not exist for public retirement programs, and the lack of such protections has resulted in gross underfunding of defined benefit pensions.

In the absence of both a mandate to fully fund pension benefits and an external guarantor, politicians have incentive to reduce contributions during times of fiscal stress. (Hess, 2005, p. 200). Hess also states that having a balanced budget requirement motivated managers to reduce pension funding further, shifting the costs and problem to successive groups of administrators. (2005, p. 200). At its core, pension fund management has to anticipate and balance the funding needs, fund growth, and contributions. Pension managers can make a fund appear more or less funded in an effort appeal to members or political masters simply by manipulating the assumptions made as part of the actuarial formula. (Hess, 2005, p. 202). Similarly, the investments made by many funds have failed to meet expected growth and performance targets as a result of the nation's overall economic performance. (Beermann, 2013, p. 27). Underfunding of public pensions benefits politicians, taxpayers and employees today at the expense of those following in their shoes tomorrow, and represents true deficit spending. (Beermann, 2013, p. 27). Interestingly, most retirement plans are actually funded more fully than social security, as employers and employees contribute roughly 12.4 percent towards social security and closer to 20 percent towards retirement benefits. (Beermann, 2013, p. 18). Estimates place the current underfunding of public pensions at between one and four trillion dollars. (Beermann, 2013, p. 12).

Retirement by Employable Persons

Retirement plans use a variety of formulas to calculate an individual employee's eligibility to receive retirement benefits. For many public sector employees the retirement benefit begins after as few as 20 years of service, leading to retirement far earlier than private sector employees. Public safety employees provide an excellent illustrative framework. In Jacksonville, Florida many public safety personnel hired are under 30 years of age. These personnel are eligible to retire at 60 percent of their annual salary once they have achieved 20 years of service; this means that a person hired at the age of 22 can retire at 42 with partial benefits or age 47 with full benefits. Many of these individuals either return to work after a waiting period or move to other departments and continue their career. (Bauerlein, 2014). Many public safety retirement plans have hazardous duty supplements or other riders that increase the attractiveness and cost of benefits to these personnel. Earlier retirement also means that the monthly pension amounts are paid for many more years than the individual who retires at age 65. A Jacksonville public safety employee could potentially draw a pension for forty years and be worth over 3 million dollars. (Bauerlein, 2014).

These types of public safety pensions are starting to draw significant public attention. Jacksonville has been working for nearly two years to try and resolve the financial crisis surrounding their pension payments. In the span of two years these pensions have doubled, reaching nearly 144 million dollars. (Bauerlein, 2014). Early retirement by public safety personnel is a multi-faceted problem; Florida has implemented a deferred retirement program that allows individuals to remain in the workforce after retiring for as many as five to eight years. These programs allow for experienced personnel to continue in key positions, but has resulted in a huge public image problem. During the deferment period, the retirement payments are actually paid to an interest-bearing trust account rather than to the retiree. The full amount from the trust is subsequently paid out in a single amount when the individual leaves employment. Even though the funds are legitimately earned and paid, reaction to payment of that deferred amount can be dramatic. Tampa, Florida Police Chief Jane Castor retired in 2009, but at the City's request, continued to work in her position as part of the deferred retirement program. When leaving employment after five years, her deferred retirement resulted in a single check of over 750 thousand dollars. (WTSP, 2014).

Fund Manipulation and Corruption

The third major challenge in public retirement benefit management arises from two of the most fundamental human vices, greed and power. Although manipulation of a retirement benefit by an individual is rare, manipulation by public administrators to the benefit of a class of workers is a threat. Often this is through a practice known as pension spiking, which takes advantage of a common retirement formula component. As discussed, many retirement plans rely on an average of an individual's highest-earning years to compute a final retirement benefit. Pension spiking is the practice of inflating salaries over a period of time to artificially inflate the pension value. (Beermann, 2014, p. 1022). Perhaps no case in recent memory illustrates this as well as the city of Bell, California. The public administrator in collusion with city council members raised pay exponentially across several years, including annual increases of twelve percent. These practices had not only the immediate impact, but also skewed the pensions for which these employees were eligible. The pension fund managers at the state level had limited recourse, for fear of establishing precedents that could be used at the state and national level. (Pringle, 2015).

Likewise, manipulation for power or political gain is a constant threat. As previously mentioned, the unions representing public safety employees represent a major voting segment. Florida politicians have largely been reluctant to challenge public safety pensions for fear of losing votes. (Bauerlein, 2014).

Reforming Public Retirement

Reforming the public retirement benefit cannot be done easily. On top of the myriad of challenges, public administrators must recognize that nearly one in four public employees do not participate in the social security system and rely solely on the retirement benefit for income. (Beermann, 2013, p. 20). Beermann cites three specific concerns for the future, if the funding crisis is not addressed. First, the fiscal nightmare that will occur when current employee retirements come due, especially given that there are record numbers of persons in public employment. Second, when forced to pay these benefits state and local governments will have no choice but to cut programs and services. Finally, there are the consequences to employees who must face retirement with reduced or eliminated benefits. (Beermann, 2013, p. 7).

Cost Containment and Benefit Reductions

Among the most hotly debated but necessary elements of reform is the need to reduce the cost of the benefits being provided. Direct cuts to a pensioner's benefits are both unpopular and legally difficult, so focusing on establishing clear rules for employees just beginning in public service. Changes such as the elimination of overtime pay and secondary employment earnings from the retirement benefit calculation contain costs while keeping the core benefit intact. Excluding allowances for things like housing, transportation, and travel can similarly impact pension costs. (Beermann, 2014, p. 1024).

There will undoubtedly be cases where benefits for those already retired or in the public service may have to be reevaluated. However, as Beermann points out, there are serious limitations to what can be done. As Detroit, Michigan found out, bankruptcy is a huge undertaking, may neither be legal nor provide the expected relief. (Beermann, 2014, p. 1007). Justification of changes to existing promises is difficult because state and local government materially contributed to the underfunding that now requires action. The primary motivation for reducing pension benefits already earned must be to eliminate that component which was not fairly earned, or an abuse of the intent of the pension. (Beermann, 2014, pp. 1018, 1026)

Privatization

The public sector must begin a transition away from the defined benefit plan. As history shows, variables in the economy, workforce, and management make accurate actuarial forecasting complex. Through shifting new personnel to defined contribution plans, government retirement benefits can be managed almost fully by the private sector and the individual employee. Many states have already begun this process, as they begin restricting defined benefit plan participation. (U.S. Bureau of Labor Statistics, 2015).

Increased Funding

Perhaps the most obvious immediate step, the practice of underfunding retirement benefits must be abandoned. This will not provide a resolution, but prevents continued growth of the problem. Increased funding is necessary even after transitioning to defined contribution, just to correct the problem inherited from prior administrators. (Hess, 2005, p. 206)

Conclusion

A secure, dependable retirement benefit has long been a cornerstone of public employment. Public administrators face a myriad of challenges as they balance the needs of the citizenry with their promises and obligations to workers. The problem, especially in the nation's most economically depressed areas, must be met with a determination to balance promises made to employees with the fiscal needs of the organization. Generally, the only solutions that can have meaningful impact are negotiating benefits changes with the highest-cost retirees, increasing funding for defined benefit plans, and transitioning when possible to defined contribution systems.

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