Pensions in the Public Sector

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Chapter 16
Public Pensions in Washington, D.C.

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When Congress granted the District of Columbia limited "home rule" in 1974, the fledgling District municipal government inherited numerous responsibilities that usually fall within the ambit of state or city government.[1] To cite but a few examples, the District government found itself both managing and financing a prison system, a land-grant university, a complete trial and appellate court system, and a Medicaid program. Although these functions were expensive—and experience would demonstrate that they would become far more costly than anyone foresaw in 1974—they could be justified as normal attributes of a government vested with home rule powers. Equally important, their costs were defrayed (at least in part) by a "federal payment"—an annual lump sum grant that the U.S. federal government made to the District as part of its annual appropriations process.

This was not the case with District pension liabilities. In addition to buildings and programs, the District inherited employees and retirees, and they came with built-in retirement costs. Congress first began to pass legislation granting pensions to District employees in the last quarter of the nineteenth century, well before the establishment of the Civil Service Retirement System in 1920 for civilian employees of the federal government, and the system expanded over time. By 1974, District employees participated in three major District-only retirement programs:

Police and firefighters. This program was established in 1916, replacing several earlier programs that covered municipal police, as well as members of the secret service and other uniformed federal police forces operating within the District. By 1974, this was the largest retirement program limited to District employees, providing pension and disability benefits to over 13,000 active and retired police and firefighters, as well as limited numbers of secret service personnel. The program had achieved notoriety for its generous treatment of disability pension applications: as of 1969, over 98 percent of the retirees had "gone out on disability."

Teachers. Established in 1920, the program covered about 12,000 active and retired teachers in the municipal elementary and secondary schools.

Judges. The newest and numerically smallest of the systems, the judges' program was created in 1974, when Congress established a new system of local trial and appellate courts.

The majority of the remaining District employees (clerks, sanitation workers, etc.) participated in the Civil Service Retirement System (CSRS), the umbrella retirement program for federal employees, which is described in detail in Hustead and Hustead in this volume.

While the three District systems had different benefit levels, eligibility requirements and administrative structures, they shared several important characteristics with CSRS. They are all defined benefit plans that allow workers to retire earlier than their private sector counterparts, and often provide subsidies for early retirements. Police and firefighters can retire at any age with 20 years' service; teachers at age 50 with 25 years' service; and judges at age 60 with 10 years' service. The District's cost-of-living allowance (COLA) scheme was more generous than even the CSRS. Retired District police and firefighters received COLAs that matched any salary increase paid to active employees, and teachers were entitled to twice-a-year COLAs. (Judges had to manage on a once-a-year COLA).

The District of Columbia 1979 Retirement Reform Act

It would have been relatively simple to draft legislative language in 1974 transferring administrative responsibilities for the retirement programs from the federal government to the District. The deficiencies inherent in the pre-1974 retirement systems were sufficiently apparent, however, that Congress delayed the transfer while efforts were made to craft remedial legislation addressing the most glaring problems. It ultimately proved impossible to pass effective legislation that satisfied the necessary stakeholders, and the resulting "District of Columbia Retirement Reform Act of 1979" (PL 96–122) had the dubious distinction of making a bad situation worse.

The process began with the assumption that the retirement programs would be transferred en bloc to the District. It was also eventually decided that the District would not be allowed to make any significant changes to the existing plan rules regarding defined benefit levels, retirement ages and accrual patterns. Thus the District would be responsible for the benefits of workers who retired before home rule, the benefits earned by current employees after the passage of home rule, and the cost of any future accruals. The only open issue was the extent to which the federal government would contribute to assist the District in discharging these retirement costs. The answer was, not much.

Inherited liabilities. Congress retained Arthur Andersen & Co. to calculate the unfunded liabilities of the District programs as of 1974, and the accountants duly reported that the figure was $2 billion. In 1978, Congress passed legislation that would have provided the District with a series of $65 million payments for twenty-five years, a formula that was reckoned to cover the benefit costs of workers who had retired before home rule (and left the costs of subsequent retirees up to the District). However, the Carter administration vetoed the measure on the grounds that it was excessively generous. By 1979, when the unfunded liabilities had grown to $2.7 billion, Congress and the administration agreed on a single $38 million payment coupled with twenty-five annual payments of $52 million. The payments had a present value of $687 million, which was supposed to cover 80 percent of the retirement benefits (and 33 percent of disability benefits) of pre-home rule retirees. The cost of post-1974 retirees would fall entirely upon the District.

Prospective contributions from the district. The most striking feature of the 1979 Reform Act was the statutory formula that set the District's posttransfer annual contribution to the programs. As long as the federal payment was in effect, the formula directed the District to pay the *lesser* of (1) the programs' "pay as you go" costs and (2) the programs' normal cost plus projected interest. What this meant, of course, was that the original $2 billion in underfunding would steadily grow. After 2004 (when the federal payment was to cease) the District's payment would rise to the sum of the programs' normal cost *plus* interest on the programs' unfunded liability.

Benefit structure. Even tentative suggestions that the DC plans' generous benefit structure warranted modification triggered objections from unions and employee groups, all of whom had excellent relations with the relevant congressional committees. As a result, only minor changes were made to the old benefit system, and even those changes were made prospective, thereby "grandfathering" most of the workforce. Teachers who retired after 1980 would receive "only" one annual COLA rather than two, and police and firefighters hired after 1980 had the salary-related COLA replaced with a twice-a-year consumer price index (CPI)-based formula. No changes were made to the judges' benefits.

Plan administration. The Reform Act created a nine-member District of Columbia Retirement Board composed of mayoral appointees and representatives from the participant groups. Contrary to what one might expect from the nomenclature, the new board did not administer the programs. Instead, tasks such as record keeping, benefit administration, and benefit payments, were all performed by the Office of Pay and Retirement within the Office of the Mayor. The board was charged with investing assets, or more accurately, selecting competing private sector asset managers to invest the assets.

TABLE 1. District of Columbia's Public Pension Plan Costs: 1979–1995 ($ million)

Fiscal year ending September 30	*District's contri-butions*	*Partici-pants' contri-butions*	*Total contri-butions to plans*[a]	*Actu-arially deter-mined normal cost*	*Excess of all contri-butions over normal costs*	*Pension plan unfunded liability*
1980	$107.6	$21.1	$128.7	$84.6	$44.1	$N/A[b]
1981	107.7	20.2	127.9	81.1	46.8	N/A[b]
1982	135.8	60.9	196.7	85.5	111.2	2,679.7
1983	142.9	22.6	165.5	94.6	70.9	2,677.7
1984	174.1	24.4	198.5	108.4	90.1	3,090.2
1985	165.1	24.6	189.7	113.9	75.8	3,190.7
1986	176.5	26.4	202.9	113.7	89.2	N/A
1987	173.4	28.5	201.9	122.1	79.8	4,213.4
1988	180.3	30.7	211.0	137.3	73.7	4,440.0
1989	194.3	34.8	229.1	121.6	107.5	4,447.0
1990	222.6	34.7	257.3	135.8	121.5	4,941.0
1991	225.3	37.3	262.6	151.0	111.6	4,505.2
1992	255.0	35.2	290.2	148.1	142.1	4,558.6
1993	292.3	36.0	328.3	140.6	187.7	4,418.2
1994	308.1	39.6	347.7	146.4	201.1	4,729.7
1995	297.8	37.7	335.5	136.1	199.4	
Totals	$3,158.8	$514.7	$3,673.5	$1,921.0	$1,752.5	

Source: Appleseed Foundation, 1996.

[a] The $52 million federal contributions required under the Retirement Reform Act of 1979, P.L. 96-122, were *not* included in these data because they did not impact the actuarially determined normal cost.

[b] These unfunded prior service costs were not readily available.

The Appleseed Foundation Report and Counterreformation

Following passage of the 1979 Reform Act, the DC pension programs developed as one could have anticipated, given the parameters established by Congress. Between 1980 and 1995, the District's required contributions nearly tripled, and the programs' inherited liabilities increased. The dismal picture is illustrated in Table 1.

The spiraling rise in annual pension costs took place against a backdrop of general financial difficulty for the District. In a nutshell, the post-home rule District faced a combination of a declining population, a shrinking tax base, and expanding costs for education, welfare, the prison system, and myriad other functions. During the administration of Mayor Kelly (1990–94), the District suspended payments to the pension programs. The D.C.

Retirement Board responded with a lawsuit that resulted in the issuance of an injunction requiring the city to make its annual payments within the time prescribed by the Reform Act.

These developments triggered an unusual response from the private sector. In 1995, a local nonprofit public interest organization composed of lawyers and other professionals operating under the intriguing sobriquet of the "DC Appleseed Center for Law and Justice" took up the study and analysis of the District Retirement Programs. The lawyers and pension professionals funded by the Center issued a report and policy recommendations in June 1996 (Appleseed Foundation 1996).

This Appleseed Report began by affirming that the District government had no responsibility for the massive underfunding of the programs. It showed that the federal government had created the benefit structure and had elected to maintain the Programs on an unfunded basis prior to downloading to the District in 1979. Since that time, the District's contributions (coupled with those of the employees) more than covered the normal costs associated with post-1979 accruals. The report further established that the investment practices of the Retirement Board were prudent and played no part in the underfunding of the programs. Finally, the Appleseed Report warned that an already-dismal situation would get even worse when the federal payments ceased in 2004. The trigger mechanism built into the 1979 Act would then require an annual contribution equal to normal cost plus interest on the programs' unfunded liability (which at that time would equal $7 billion) or $490 million. As the report dryly noted, by that time the District's pension costs would exceed its payroll. Moreover, this heroic expenditure would not reduce the principal of the inherited unfunded liabilities: *that* would require an additional $300+ million a year.

Once it had established that the existing system was doomed, the Appleseed report recommended several proposed changes. It argued that the simplest and fairest method of dealing with the District pension problem was for the federal government to reclaim the District's pension plans. Under this scenario, the federal government would accept financial responsibility for all of the pension programs' benefit costs associated with retirees, active employees and former employees with benefits vested as of the transfer date. The federal government would also receive all the assets held by the pension programs.

The District would then be free to establish new benefit plans covering new hires. The District would have full control over selecting the structure and benefit levels of the new plans—the report went so far as to suggest that the District adopt a defined contribution structure—and the District would be solely responsible for funding them. The District would also provide the federal system with an annual payment equal to the normal cost of the post-transfer benefit accruals earned by the transferred participants.

All too often, public policy analyses and recommendations lie unread, but the Appleseed Report proved to be an exception to the rule. During the summer and fall of 1996, the Foundation's board and staff conducted a remarkably effective education campaign before the Congress, the D.C. Council, and the Clinton administration's Office of Management and Budget. The foundation also obtained solid support from the local news media, as stories and editorials in the *Washington Post* began to stress the urgent need for solutions to the District's pension problem.

In the last week of 1996, President Clinton approved the basic elements of a legislative proposal to address the fiscal and management woes of the District. The first element of the package contained a modified version of the approach to the pension problem presented in the Appleseed Report. Other aspects of the proposal called for a federal takeover of the District's prison, court and criminal justice system, the federalization of the District's tax system, and other elements too numerous to mention here.

In February 1997, the Office of Management and Budget (OMB) summoned representatives from numerous Federal agencies and departments to a meeting in the Treaty Room of the Old Executive Building, to outline the proposal and assign drafting responsibilities. Responsibility for drafting the pension proposal was entrusted to staff of the National Economic Council, the Treasury, OMB, the Department of Labor, and the Pension Benefit Guaranty Corporation (PBGC). Drafters were told to take all the time they needed, so long as the legislative language and proposed descriptive material was finished within three weeks. While most aspects of the bill (prisons, taxes, courts, etc.) ended up requiring several months to draft, the pension team actually completed a passable draft before the three week deadline.

The District of Columbia Retirement Protection Act of 1997

The resulting bill outlining the Administration's proposal to assume the District's unfunded pension liability was introduced as part of the "National Capital Revitalization and Self-Government Improvement Act of 1997." A version of the Administration's proposal passed Congress relatively quickly, and "the District of Columbia Retirement Protection Act of 1997" became effective in October of 1997. (It appeared in Title XI, Subtitle A, of the Balanced Budget Act of 1997, PL 105-32).

In drafting this pension law, the Administration faced two major constraints. The first was that the federal government's assumption of the District's unfunded pension liability could not impact on the recent agreement to balance the budget by the year 2002. For that reason, the federal government could incur no costs before fiscal year 2003. The second constraint was the lack of any department or agency within the federal government with experience or knowledge in administering a public pension plan remotely similar to traditional state and local government pension plans.

Following roughly the model set out in the Appleseed Report, the Act divided the $3.9 billion in pension program assets between the federal government and the District. The Act specified that the District would keep $1.3 billion, which would be used to help fund the replacement programs that the District would establish. The remaining $2.6 billion would migrate to a new Federal Trust Fund with no restrictions on the investments. Permitting investments to continue in the private sector avoided converting the assets to an internal fund. Conversion to federal funds would have reduced the deficit in the year of the conversion but, by drawing on federal funds within the budget for benefits, would have increased the deficit in each succeeding year. This provision satisfied the first constraint mentioned above—assets in the trust fund would be sufficient to ensure that no new net costs resulted in any year prior to 2003. The new fund would be sufficient to pay all federal obligations assumed in the Act until well after the year 2002. A second federal fund invested entirely in federal securities was also established to pay benefits after the assets of the federal trust fund were depleted. The act provides that the new fund will receive annual federal payments (drawn from annual appropriations) in an amount determined by accepted actuarial methods to amortize the original unfunded liability.

The act transferred all liabilities and administrative responsibilities for the smaller judges' plan to the federal government. With respect to the Teachers Plan and the Police and Fire Plan, the act transferred responsibility for paying the retirement benefits of plan participants who retired before June 30, 1997, to the federal government. The responsibility for paying pension benefits to new District employees remained with the District, in the form of whatever replacement plans the District decided to adopt.

Diverging from the Appleseed proposal, the act split both financial and administrative responsibility for current District employees between the Federal government and the District. In rough terms, benefit accruals for the federal portion of the employees' benefits were frozen on June 30, 1997, with the federal government responsible for the prefreeze portion. While the federal government will not be responsible for benefits earned by current employees in future service years (other than judges), their federal benefit will reflect pay increases on the frozen benefit. Frozen benefits will also continue to be subject to cost of living adjustments. All future disabled retirees' benefits were the responsibility of the District. The act also pledged the full faith and credit of the United States to meet its responsibilities to pay benefits for the Police and Teachers Programs.[2]

Any benefit subsequent to the freeze for current workers would be determined by the terms of the District's replacement plans. The drafters had no way of knowing what type of replacement plan the District might choose, and they sought to draft provisions that would not limit the District's choices for a replacement plan. As in the past, however, political realities overcame actuarial theory, and the District Council dutifully enacted a replacement plan for Teachers and for Police and Fire that was substantially the same as the existing plans. Curiously, this did not have an adverse effect on the District's cash flow because the $1.3 billion left behind by the act covered plan costs for the foreseeable future. The District plans have also been placed on a sound actuarial basis to avoid future financing shortfalls.

The act placed responsibility for administration of the trust fund and benefits with the Department of Treasury. (It is a matter of record that no other federal agencies were eager to accept this job.) To deal with the lack of experience at Treasury in administering public pension plans, the act allowed the secretary to delegate much of the responsibility to third-party trustees. The secretary was also given broad regulatory powers under the act. The trustee or trustees were empowered to invest funds, manage the existing plans, and make payments on behalf of participants and beneficiaries. The act called for cooperation and an exchange of information between the District, the District's Retirement Board, and the Treasury Department. These parties have entered into Memorandums of Understanding to coordinate both the transfer of assets to the federal trust fund, and benefit administration.

The Omnibus Consolidated Act of 1998: Pension Protection Protected

By this point, it may be evident that governmental pension reform has proven to be a never-ending process, and this conclusion was reiterated with the Omnibus Consolidated Appropriations Act of 1998 (OCAA 1998). Among other things, section 801 of the law permitted the secretary to allow the pension trustee contractor to hire subcontractors. One should not infer that this was a gesture of confidence in favor of contracting, because another change in the same section clarified that the secretary could have work performed by Treasury employees instead of contractors. The act also allowed the secretary new authority in determining exactly *which* assets should be left behind with the District, a point that had apparently caused controversy.

October of 1998 saw the passage, *twice*, of a myriad of corrections to the judges 1997 legislation. The District of Columbia Courts and Justice Technical Corrections Act of 1998 (Public Law 105–274), managed to secure full faith and credit for the judges' pensions, along with several other changes stretching the meaning of "technical corrections." Apparently concerned that simply getting these corrections passed once was not enough, hours later the exact same set of provisions was enacted into law as section 804 of OCAA 98.

Section 130 of the 1998 amendments merits careful attention. The 1997 legislation had given the Secretary broad authority to invest the old DC pension program assets including permitting investment in private securities. The ability to continue to hold and invest the pension program assets outside the federal budget was necessary to avoid increasing the Federal deficit. The 1998 amendments eliminated investment discretion altogether in favor of "public debt securities" of the United States. By 1998, annual projected surpluses were large and there was no deficit to increase. Instead, the then current need was for spending increases to allow Congress to pass unrelated legislation with offsetting costs. In other words, the arcane rules of deficit reduction, applied in times of surplus, had led the D.C. pension retirement financing back to investment in federal debt issues.

Conclusion

We have at last, therefore, come full circle. Today, a portion of the pensions of D.C. employees accrued before 1997 are again backed by the federal government's own securities and promise to pay. Employees with pension accruals after 1997 are the responsibility of the District. Continued federal government intervention in the District of Columbia's pension system is a near certainty, judging from events over the last thirty years.

Notes

1. The District of Columbia is the capital of the United States, and as such the District is treated differently from states or municipalities in many ways. The legal structure outlining how the nation's capital is governed is spelled out in The District of Columbia Self-Government and Governmental Reorganization Act, P.L. 93-198.

2. The legislative provisions dealing with the judges (drafted by the judges themselves) neglected to obtain a similar commitment.

Reference

Appleseed Foundation. 1996. *The District of Columbia Pension Dilemma: An Immediate and Lasting Solution.* Washington, D.C: Appleseed Foundation.