Pensions in the Public Sector

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Workers of the nineteenth century would marvel at the current face of the American workforce. Most obviously, women have entered the workforce in record numbers, the nation's general education level has increased, public unions have grown, and new industries and services have developed. But what would truly amaze those bygone workers would be the benefits enjoyed by many of today's employees. This boom in employer sponsored benefits is the product of demands from a changing, diverse and organized workforce, and wide range of economic conditions favoring benefit growth over increases in salary, such as the wage freezes of the second world war and during the 1970s. Yet the growth in employee benefits is far from a static development. Rather benefits specialists have come to recognized that it takes a dynamic and constant rebalancing of salary and benefits, if employers are to effectively integrate their human resource objectives with those of their workforces.

This chapter traces key workplace trends in the society at large, and then discuss how they have been mirrored in the public sector. In addition, we outline how these trends will influence designers of public employee benefit plans for the twenty-first century. In particular, we argue that retirement systems and expanded employee choice will be essential in attracting and retaining the ideal mix of workers for public employers in years to come. This is because public employers are now recognizing that they confront new and diverse compensation as well as benefit challenges. Competition with the private sector for employees has intensified just as public employers are reevaluating the relationship among personnel, compensation and benefit policies. These will strongly influence the future evolutionary path of public-sector pension benefits design and policy.
Workforce Developments

Key workforce trends that will shape compensation strategies in the next hundred years including population aging, technological change, and new work patterns. Demographers have recognized that the United States will experience a large increase in the fraction of elderly: in 1970, persons 65+ accounted for 9.8 percent of the population, and this figure will rise to 13.3 percent by 2010, and over 20 percent by 2040 (Bureau of the Census, 1975; SSA 1997). One result of this pattern is that employers will seek to retain older workers, as there will be too few younger workers to fill available jobs.

To appeal to older workers, it is likely that there will be pressure to constantly revisit and revise compensation structures. One response, already starting to be seen in practice, is that companies will implement programs with financial incentives embedded in them to induce more worker productivity. Examples include pay for performance, bonus plans, and gainsharing, as well as flexible benefit arrangements permitting employees to choose benefits that best suit their individual needs from a specified list or menu given a specified budget of benefit dollars. For example, an older worker could purchase long-term care insurance, while a younger worker might opt for childcare benefits.

A related workplace shift that has already begun and will greatly influence future benefit design is the movement away from a permanent, full-time workforce to more temporary, part-time, and contract employees. Employers seeking to remain competitive while meeting the needs of their customers on a project-by-project basis will increasingly find that a flexible staff allows more customization of the workforce to the product. Employee teams will be molded to meet clients needs, probably with some permanent employees and supplemented with temporary or specialty employees. Chat groups and e-mail is being used to create a team of workers without using physical office space. Video conferencing allows employees to interact visually, without leaving their individual locations. A specific area where this is occurring is in the information/technology field, where employers are already experiencing difficulty in locating, hiring, and retaining these specialists (Virginia Polytechnic Institute 1998; Violino 1999). With team development and shifting skill needs, employers must design an entire work environment—including benefits—that will both attract employees for short-term assignments, while also providing meaningful benefits to permanent employees.

A more flexible workplace is also facilitated by technological change which will allow employees to be increasingly flexible about where and when they work. The development of the "virtual workplace" concept, and telecommuting, are hallmarks of this movement (Crandall and Wallace 1997).
Many firms still use paper communications media, but increasingly they must expand electronic communications with their constituents. This applies to public as well as private sector entities: for instance, governments are increasingly using the Internet for tax filing or providing information and forms. In our view, the greater value accorded technologic skills will likely drive two trends in employment benefits. First, younger workers will become relatively more attractive, inasmuch as they often have more of these skills than do older workers. As a result, benefits will be designed to attract and keep these younger workers. But second, because of the anticipated shortage of young workers, employers will be faced with the necessity of offering technology training and educational benefits to attract and keep employees of all ages.

**Changing Retirement Patterns**

In addition to workforce changes, the nature of retirement is evolving as well. Americans' life expectancy is expected to continue to rise in the foreseeable future, a trend that will inevitably drive demands for more retirement income. Thus in 1940, a 65-year-old man could expect to live another 12 years; by 1997 this had risen to 15.5 and it is soon expected to be 20 years. His 65-year-old female counterpart could expect 13.5 more years in 1940; by 1997, it was 19 years, and her life expectancy too is expected to keep rising over the next quarter-century (The Concord Coalition 1998; Employee Benefit Research Institute 1999).

The lengthening of the retirement period also comes at a time when the nation has recognized that important reforms are needed in our social security system to maintain program solvency. Although the choice of specific policies has not yet been resolved, likely changes will probably include changes in the benefit eligibility age(s) or levels, increases in the tax rate or base, adjustments to inflation indexation, or perhaps the establishment of individual investment accounts (Mitchell et al. 1999). As the social security normal retirement age rises from 65 to 67, and perhaps later, some people may delay retirement, while others may switch careers, working on a new or "bridge" job until they reach social security eligibility age. Such a reform could induce many workers to remain in the labor force longer. A similar effect might follow from a change in the amount of money that a retiree can earn before social security benefits are partially or fully reduced. If this limit were increased in the future so that retirees would not lose social security benefits with each dollar earned, elderly individuals would have a greater incentive to work after beginning to receive benefits.

The possible impacts on work patterns of more far-reaching changes in the social security system are more difficult to predict, although some might induce extended worklives particularly among women workers. For in-
the General Accounting Office (GAO 1997) recently concluded that women’s short labor market attachment period translated into lower benefit amounts, despite the fact that the rules are gender-neutral on their face. The agency also found that individual account plans might lower women’s benefits relative to men’s, depending on the way the reform was structured.

**Issues Specific to the Public Sector Workforce**

These trends just described influence employers and employees as a whole, but in addition there are several factors likely to be particularly salient in the public sector. It is worth noting that state and local government employment is projected to grow at an overall rate of only 1 percent annually over the next decade, below the 1.3 percent employment growth rate expected for the overall economy. As a result, the fraction of workers in state and local government is projected to fall just slightly, from 12.4 percent in 1986, to 12.2 percent in 2006 (Franklin 1997). Inasmuch as the public sector workforce is not growing in relative terms, it will also be expected to age somewhat.

As this process continues, the government sector as an employer will become more competitive with private sector firms, particularly for employees with high-tech skills. The public sector workforce today is heavily dominated by service, teaching, and public safety workers. It is reasonable to expect that governments will continue to employ relatively more women because of the high concentration of teachers in this workforce. But some changes are likely to be felt. For example, the public sector has had a specific mandate to provide public safety, particularly through the police and firefighting forces. In the past, employees tended to join the uniformed services in their early 20s, and could retire at 50 or 55 years of age from these physically demanding positions. A shortfall of younger workers will no doubt mean that state and local governments will face increasing pressure to keep staffing levels up. In the future, we also anticipate that technological services such as Internet expertise will be in more demand, driving public employers to compete in this increasingly sophisticated labor market.

**Implications for Benefits in the Public Sector**

What will be the consequences of these changes for public sector compensation and employee benefits? One is that governments may need to increase salaries for particular jobs and occupations. As an example, some states and municipalities are already exploring multiple pay structures, which permits the rebalancing of compensation away from tenure, and toward specific skills for which there is stiff market competition. Related to this is the fact that as competition for employees drives up salaries, state and local gov-
ernments will need to take a total compensation perspective that combines salary and benefits into a single budget item. Managing these costs in a wholistic way will be needed to balance salary and benefit program costs. It is also likely that benefits packages in the public sector will need to become more flexible. It has been observed that employees who are parents may value benefits differently from their single counterparts, placing high importance on childcare. Others who have aging parents will tend to value eldercare and long-term care insurance benefits more highly. All employees have tended to place high value of flexible work schedules, as well. In the future, public employers will need to develop benefit packages that are flexible enough to attract and retain the needed workforce for these positions. Careful restructuring of health insurance benefits may also be another method of retaining and attracting older workers, though cost considerations require careful attention to these offerings.

As this process unfolds, public employers will evolve from being benefits providers to being benefits facilitators. That is, instead of the employer offering a single plan that covers all employees, the new model will have the employer assisting employees to find the right benefits combination for their situations. Part of this new role will include employer education, instructing employees how to meet their long-term financial goals. This facilitator role must engender a new view of benefits from both the employer’s and employee’s perspective. The employer challenge will be to offer benefits that are valued by employees at various career stages. From the employee perspective, more options will be available, but in turn this will require the worker to take more responsibility in planning for his or her financial needs.

**Drivers of Public Pension Redesign**

In the particular case of public pensions, many state and local governments will find that the changing workforce requires a number of design changes. For instance, some will seek to update their pension system to retain older workers who will carry forward the institutional memory of processes, procedures, and history as technological changes are implemented. In other cases, a pension might be adapted so as to encourage retirees to return to work, which is feasible if governments permit the accumulation of additional retirement benefits for "unretirees."

One factor deserving note is that state and local employers often have rules restricting how much a former worker who has retired can earn if he or she returns to work for the same employer. In some cases, these rules also limit reemployment at any participating government in a combined retirement system. In such a case, should the older individual return to the public sector employer or work "too much," the pension benefit paid may be reduced or suspended. Naturally, such limits can be a barrier to work at
older ages. Earnings limits do not apply if the retiree is receiving benefits from a private employer and is now working for the government, nor when a retiree from a government works in the private sector.

As public plans recognize a need to retain older workers, and retirees seek to earn some additional income, public pensions will need to review their return-to-work limits. A recent examination of 105 statewide pensions found that there are two primary types of earnings limits: loss of retirement benefits for any work, or reduction in retirement benefits when a retiree has worked over a set limit (PRI, 1999). Such limits include working over a particular number of hours each week, earning more than a specified amount, and working more than a given number of weeks per year. The survey found that all but two of the 55 respondents imposed some type of earnings limit on retirees who returned to work for their prior employer; the earnings limit centered at around $13,500 per year (or 730 hours). It also found that 89 percent of the plans also imposed a limit if the retiree worked for any employer who participated in the retirement system. The most commonly used limit involved benefit suspension while the retiree is reemployed (58 percent); many also require that no additional benefit may be earned while reemployed (36 percent). Numerous systems (30 percent) impose limits on the number of hours that can be worked or the level of earnings allowed (32 percent) permitted before retirement benefits are reduced. In addition, thirty-six of the fifty-three plans with restrictions had two or more restrictions. For example, a plan might allow participants to choose between several options of how to alter their retirement benefit when they became reemployed.

Another factor that may drive public pension redesign is a controversial proposal that would require all state and local employees to participate in social security. For the approximately 5 million state and local government employees, or a quarter of current public employees, currently outside of social security and their employers, a requirement of universal participation would require plan redesign, increased cost and/or reductions in benefits from the employer plan. This transition would be very costly, on the order of $26 billion over five years (The Segal Company 1999). Further, the General Accounting Office (1998) has concluded that this reform would extend the systems' solvency by only two years. If it were enacted, many jurisdictions would need to completely reassess their total compensation packages. For example, social security earned income limits differ from state and local government earning limits just described. Social security retirement ages also differ from those in the public pension sector, and many governmental plans pay supplemental retirement benefits until a retiree grows old enough to receive social security. Evidently, changes in social security ages would in turn affect public plan costs. Finally, it must be recalled that the public sector tends to hire relatively more women and it employs public safety per-
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Encouraging Employee Saving

It appears that public employers in the future must seek to encourage additional employee saving, if they are to achieve target income replacement ratios of 75–80 percent (Salisbury 1997). One way to help state and local employees achieve this goal is to conduct a strategic plan review. Such a review would ask the following questions:

- What personnel objectives is the plan sponsor trying to accomplish through the plan's design? Is the plan meeting these objectives? Are the benefits competitive?
- What income replacement is provided to retirees? Is this rate achieved for most or only a few retirees? Can the plan sponsor afford to provide a higher income replacement goal? Are there retirees or others terminating employment with little retirement income or savings and are there options to assist those individuals? Should the replacement rate be preserved in real terms with inflation adjustments?
- Are employees doing any saving privately, and what vehicles are they using (e.g., IRA, 457 plans, etc)? Should the employer provide more retirement saving opportunities?
- Are employees covered by social security, and what can that system be expected to provide in the future?

As a result of a plan review, the state of Missouri recently instituted a match of employee contributions to its section 457, and in so doing has leveraged employee saving quite successfully. When an employee contributes to this plan, the employer matches up to $25 monthly in a separate account: as a result, participation in the section 457 plan grew from 30 to 70 percent in just two years. Due to the program's popularity and its manageable cost the state has authorized but not yet implemented a new, higher monthly match of up to $75. Similar state programs have been instituted in Oklahoma, Tennessee, and Maryland.

Developments in Portability

In addition to efforts to enhance saving incentives, public sector pension plans are also moving to facilitate portability. This refers to the ability to carry one's retirement accumulation or credits as the employee moves between employers. In an era when the employee remained with a single em-
ployer during the entire career, portability was not a concern. However, today portability can mean the difference between a comfortable retirement and needing, rather than wanting, to work through retirement (see Fore, this volume). Two methods are available for making pensions portable: dollar portability or service portability. In a defined contribution plan, the size of the retirement benefit depends on the funds accumulated in the individual's account. Portability may be achieved by transferring funds from a former employer's defined contribution plan account to an individual retirement account (IRA), or to the new employer's plan. In a defined benefit plan, the retirement benefit depends on the retiree's years of service and salary as specified according to a formula. In the public sector, pension portability may be accomplished by permitting the mobile employee to transfer service from one employer to the next. This occurs when a monetary amount is transferred between plans, equal to the value of the worker's accrued benefit. Portability is often thought to be more difficult in defined benefit plans as compared to defined contribution plans, because of the role of assumptions in the valuation of employee accruals.

As public sector employers find they must compete for employees at all age levels and with different benefit preferences, some have already added portability options to their plans. Some portability provisions are attached to defined benefit plans, though some governments have established defined contribution arrangements for all new workers or for a specific subset of employees. For example, the state of Michigan established a defined contribution plan for all new state workers in 1997. In the same year the state of Vermont instituted a defined contribution plan for elected and appointed officials who, through the power of the ballot box may experience higher job mobility. This focus on portability is also influencing the growth of section 457 or 403(b) plans, which are public sector deferred compensation plans similar in concept to section 401(k) plans (Bureau of Labor Statistics 1996). Section 457 and section 401(k) plans are types of defined contribution plans. A section 457 plan account balance from a previous public employer can be transferred to a new public employer's 457 plan without any tax implications. The same is true between section 401(k) plans. Further options may emerge if the federal government passes tax law changes that would permit almost complete portability between and among retirement arrangements. The ability to carry assets from one employer to the next is one type of portability that can preserve the benefits as well.

Three factors unique to public sector defined benefit plans provide some portability under current rules: employee contributions, purchases of service credit, and reciprocity agreements. As noted above, most public sector employees are required to make some contribution to their pension plan (Mitchell et al. this volume). Generally, when employees leave their public sector employment before retirement and they have been required to make
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contributions, these contributions are returned to them, often with interest. These contributions can then be placed in a subsequent employer defined contribution plan or, in some cases, a defined benefit plan. Purchase of service credit arrangements allow mobile employees to "purchase" years of employment with their new public sector employer. This is common for those serving in the military: for instance, a two-year veteran of the armed forces who then works for a state government for 35 years could, if allowed by the state government, add the two years of military service to his benefit formula by "purchasing" or contributing the cost of the additional service to the plan. The retirement benefit under the state government plan rules would then be calculated using 37 years of service. Most state plans permit this (92 percent) and half of local plans do as well (PRI 1998), generally up to a capped number of years. A third portability approach entails reciprocity agreements between state and local government plans (usually within the same state). Such an agreement would permit two employers to transfer service, funds, or both for people changing jobs if they had worked for two or more employers covered by the agreement. Some 40 percent of statewide plans participate in this type of reciprocity agreement (PRI 1998). It is to be anticipated that similar provisions will proliferate in the future, to accommodate employees seeking portability.

Two additional portability provisions have recently been added to the set of public plan options, distinguished according to whether they offer "front-end" or "back-end" portability. Front-end portability pertains to decisions made around the time someone is initially hired. For example, it is common for public universities to offer new teaching staff a choice between a statewide defined benefit plan and an individual-account model defined contribution plan. Back-end portability provisions specify how employees may receive their benefits at or near retirement. One variant on this theme is the so-called "deferred retirement option plan," known as a DROP plan. This refers to a plan permitting employees to contract to retire at a specified future date (generally as much as five years ahead). The retirement benefit is then frozen as of the current date, and any future retirement accruals earned are paid as a lump sum at retirement. At retirement the individual receives a pension benefit from the general plan and a lump sum from the DROP. This lump sum can then be rolled into an IRA to accumulate additional retirement assets. Giving employees distribution options of this type in the context of a defined benefit plan increases flexibility in response to employee demands.

To illustrate some of the more innovative provisions related to portability we turn next to some salient examples. For example, the Ohio State Teachers Retirement System allows employees to compute benefits two ways, as a defined benefit plan, or as a money purchase plan (which is a type of defined contribution plan). Under the money purchase alternative, the em-
ployee may take part of the employer's contributions and interest when they leave employment; thus someone with under three years of service receives the employee contributions plus four percent interest, while someone with more than three but less than five years service receives contributions plus six percent interest. A participant with five or more years in the plan would receive 50 percent of the employer matching contributions. Another public pension pioneer in this arena is the Texas Municipal Retirement System (TMRS), which has a cash balance plan. In this structure, workers accumulate an account balance that is credited with interest; the TMRS cash balance plan guarantees a minimum rate of return, but not the benefit amount (assets are invested by TMRS and are not self-directed.) If the participant separates from service before vesting, then he or she can take the account as a lump sum benefit. A participant's annuity is the actuarial equivalent of the sum of the participant's own monthly contributions plus interest during working years and an equal or greater multiple sum out of the employer's accumulation account plus interest. TMRS also provides a partial lump sum distribution based on a participant's last three years of contributions at retirement.

As a final example, the Colorado Public Employees Association (COPEERA) instituted its current plan in 1995, at which time it added a money purchase retirement plan to its set of pension options. Similar to the Ohio State plan, plan assets are invested by COPERA and are not self-directed. Retiring employees may choose between the higher of a defined benefit or a defined contribution amount. The money purchase benefit is calculated using the value of the participant's contributions and interest on these funds since the date of membership. The total amount then is converted to a lifetime benefit using the retiree's life expectancy or that of their co-beneficiary. A participant who terminates prior to retirement eligibility receives his/her contributions, a 25 percent employer match and interest on the total amount. Individuals who are eligible to retire can take a lump sum distribution or an annuity. The lump sum distribution is equivalent to the participant's total contribution, a 50 percent employer match and interest. Interest is credited at 80 percent of the assumed actuarial rate.

**Conclusion**

A major challenge facing public-sector employers in the next several decades is their ability to respond creatively to workforce and retirement trends. Compensation and benefits structures must support career, core, and contingency workers and the increased competitiveness of the workplace will require a rebalancing of pay and benefits policy. This process will not be static; rather, continued redesign will be needed to encourage evolving employee behaviors. Benefit plans, and pensions in particular, will have
to be increasingly flexible, accommodating new work and retirement patterns. Employee choice will be essential in attracting and retaining the ideal mix of workers for each employer. Governments will continue to move away from the role as the sole provider of benefits to one of a partner or "facilitator" of benefits. Increasingly, individuals will take more responsibility for managing their benefits. Augmenting education about benefit choices, investment approaches and financial planning will intensify for all employers. Portability in pension will be needed to attract and retain younger and more mobile employees, as well as to appeal to older people seeking reemployment. These features will place more responsibility on employees to manage and preserve their retirement assets, and will lead employers to better educate those who must manage their own financial matters.

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