Retirement Systems for Public Employees

THOMAS P. BLEAKNEY, F.S.A.
Consulting Actuary, Milliman and Robertson, Inc.

Published by the

Pension Research Council
Wharton School of the University of Pennsylvania

Distributed by the

University of Pennsylvania Press
Philadelphia

Fifth printing 1991 by the University of Pennsylvania Press

Library of Congress Cataloging-in-Publication Information

Bleakney, Thomas P.
Retirement systems for public employees, by Thomas P. Bleakney
(Pension Research Council Publications)
Published for the Pension Research Council, Wharton School of the University of Pennsylvania
xvii, 205 pp. 23 cm
Includes bibliographical references and index
1. Local officials and employees—United States—Pensions. 2. Local officials and employees—Canada—Pensions. 3. Civil service pensions—United States—States. 4. Civil service pensions—Canada—Provinces. I. Title. II. Series.
JS361.B53 72-90774
ISBN 0–256–01407–8 CIP

ISBN 0-256-01407-8 CIP

Printed in the United States of America

Chapter 1

An Overview

As a practical matter, the provision for an employee's non-productive years is a joint responsibility of the individual, his employer, and the government. Whether for good or ill, an increasing share of this responsibility is being borne by the government (through social security programs) and by employers (by means of formal retirement systems). This book is concerned with the problems of retirement systems established by governmental bodies in their roles as employers.

The term *public employee retirement system* is widely used throughout this book. The term refers to a state, provincial, or local retirement system covering public employees in the United States or Canada. Not included are the retirement systems for civilian and military employees of the federal governments of the United States and Canada. Also excluded are the federal programs of old-age benefits under social security,[1] although the effects of these programs on benefit design and cost are discussed.

[1] The term *social security* will be used to refer to these programs in each country, even though this usage of the phrase has not received the same broad acceptance in Canada as it has in the United States. The programs encompassed by the term in Canada will be the Old Age Security Plan, the Canada Pension Plan, and the Quebec Pension Plan.

The payment of benefits to a retired person or his beneficiary is an outgrowth of the employment relationship. The cost of providing such benefits may be considered as part of the payment for the services rendered. However, there is a substantial time lag between performance of the services which give rise to the benefits and their payment. The employee who first becomes covered by a retirement program at age 25 may still be receiving retirement income when he is 85 or 90. On the average, there is a 30 to 40 year lag between the service for which retirement income is a reward and the time when retirement benefits are paid.

It is thus apparent that the establishment and management of retirement programs involve long-range considerations. The purpose of this book is to give those who are concerned with public employee retirement systems an understanding of these considerations. The issues involved in the management of these plans will be explored. Hopefully there will be some helpful guidance imparted to those charged with the responsibility of establishing and maintaining these systems.

THE SCOPE OF THE SYSTEMS' COVERAGE

The first public employee retirement system in the United States was established in 1857, covering New York City policemen. The next half century brought other municipal plans into existence, including a number of systems for teachers. It was not until 1911, though, that Massachusetts became the first state to develop a system to cover its general state employees. Since that time membership in public systems has grown until it is now nearly universal among nonfederal employees, covering over 90 percent of state, provincial, and local employees in the United States and Canada.

The systems themselves number approximately 2,300. They range in size from the three largest, whose combined membership exceeds one million, to the majority in number, each of which covers less than 100 employees, a handful having only a single member each. In total, these systems provide benefits for approximately eight million employees and their beneficiaries.

The membership extends over almost the entire gamut of occupations, from accountant to zoologist. Included are nearly all of the teachers at all scholastic levels and most of the continent's judges, firefighters and policemen, as well as the majority of its much-maligned bureaucrats.

The most important benefits these retirement systems provide are awarded to employees who complete the necessary age and service requirements for retirement. Nearly all systems also provide death and disability benefits, both for injury on the job and sickness or injury off the job. The death benefits take many forms, including continuation of retirement benefits to a survivor after the death of a retired employee or a pension or cash benefit to a survivor upon the death of an active employee.

While benefits can be provided without the formality of a written document, this is neither practical nor advisable for large employers and may not be legally possible for governmental bodies in the United States and Canada. Written provisions help to assure uniform treatment for all employees and to facilitate orderly retirement as the employees complete their working years. A well-conceived program of benefits will enable retired employees to live in reasonable security. It will also serve as an instrument for attracting new employees and retaining existing employees.

The written provisions of a public employee retirement system may either take the form of law, as is common for the large systems, or be embodied in a formal plan document similar to those used for the same purpose in the private sector. However constituted, the system's governing provisions will define:

1. Who is eligible and how those who are eligible become members of the system;
2. What benefits accrue and the conditions governing their payment;

3. How the costs of the system will be shared between employer and employee.

CONTROL OF PUBLIC SYSTEMS

There is a significant difference between public and private retirement programs with respect to the decision-making process. A private company's self-interest is best served if proposals for the establishment or change of a retirement plan for the company are evaluated by competent actuaries and reviewed by the company's financial officers before action is taken. If the plan is subject to collective bargaining, the cost of each improvement in benefits is recognized as a part of the package of payroll costs. In well-managed companies, any action to increase or modify retirement benefits is made with full knowledge of resulting cost implications.

In contrast, the level or kind of benefits to be provided in public employee retirement systems and the financing of those benefits are subject to decisions made under pressure in a political atmosphere. Ideally, orderly procedures should exist to assure that the cost implications of liberalization of eligibility provisions and benefit levels are evaluated before the legislators are asked to take action. Rarely do such procedures exist, and even where they do, they frequently work imperfectly. The result is that all too often the problem of financing new or improved benefits under public employee retirement systems is not confronted until after the employer is firmly committed to the increased benefits.

A new element has been introduced in recent years as public employees have won or enlarged the right to bargain collectively. Changes in eligibility or benefit provisions in retirement systems have thus become the subjects of negotiations between representatives of employee groups and their employers at the state, provincial, or local level. Deep conflicts may arise if an agreement reached by such a negotiation fails to be ratified by the legislative authority governing the system. The problem is especially acute if the negotiation is with a local governmental body but the required amending legislation is at the state or provincial level.

THE NEED TO KNOW COSTS

By the very nature of pension obligations there is a time lag between the accruing of pension rights and the payment of benefits. If funds are set aside and invested at the time pension rights accrue, part of the money necessary to meet the benefit payments can be provided from the resulting investment income. There are strong arguments for funding the costs of retirement benefits during the period of services upon which the employee's benefits are founded. Despite these arguments, however, some political entities, either as a matter of policy or as a result of budgetary pressures, elect either to do no funding or to provide only partial funding of pension benefits.

Whatever the policy in this regard, if a legislative body is to operate in a financially responsible manner in reviewing a proposal to modify a public employee retirement system, it must be adequately informed as to the proposal's expected costs. These costs may be presented either in terms of the expected incidence of benefit payments over a number of years or as the amount required to meet the cost of the benefits as they are being earned. In either event, the calculations should be performed by a qualified actuary[2] who is trained to make such evaluations competently.

Presentation of data of this sort will keep the legislature fully advised in advance of the cost implications of any change which it might make in a public employee retirement system. One important reason for the legislature's being so advised is that the provisions of many retirement systems for public employees are viewed by the courts as having the status of employment contracts. This view prevents the provisions from subsequently being modified to the detriment of

[2] Laws or regulations in many states permit services of this type to be performed only by qualified actuaries. Definitions of a "qualified actuary" often include membership in the American Academy of Actuaries.

any employee covered by it at the time of change. Thus a legislature cannot recant on the granting of overly expensive improvements in benefits.

THE FUNDING QUESTION

As already indicated, a policy which assures that the legislators are aware of the cost implications of proposed pension plan changes before acting upon them does not necessarily govern the actual monetary commitments for the resulting costs. Regardless of the financing method adopted, the ultimate outlay will be dependent upon the actual benefit payments made, increased by the administrative expenses incurred, and decreased by the investment income earned upon any accumulated funds. Except for any differences in investment earnings resulting from differences in the size of the funds, the ultimate costs, then, will be the same, whatever financing method is adopted. Why, then, fund pension costs in advance?

A strong case can be made for the proposition that retirement benefits constitute a form of deferred, contingent, additional compensation for the services of the employee. If this proposition is accepted, then the cost of such compensation must be regarded as an expense to be recognized at the time the services are performed. If the conditions of the retirement program are met by an employee (i.e., if he remains in employment for the necessary period of time, makes any necessary contributions, and survives to the time of eligibility for benefit payments), then he is entitled to the utmost assurance that he will be paid the additional compensation to which he is entitled as a result of his service for the employer. Meeting of the costs of retirement benefits as those benefits are earned will create a fund which the employee can look to for such assurance.

Another argument for meeting the costs of pension benefits as services are performed is that the investment income earned on the funds thereby developed can substantially reduce the employer's ultimate payment for such benefits.

Finally, although it may be difficult or distasteful to raise taxes or defer other desired projects in order to fund pension costs on a current basis, there is little reason to believe that such alternatives will be less burdensome in the future.

Some or all of these propositions have been disputed. Some persons contend that pension costs constitute a gratuity and are not a form of deferred compensation. Indeed, one court has stated that pension benefits for governmental employees are in the "nature of a bounty springing from the appreciation and graciousness of the sovereign."[3]

Others, while accepting the additional compensation concept, do not concede that this logically requires that the expense of such additional compensation be met while the services are being performed. With respect to the need for security,[4] it is contended that the taxing power of the state provides adequate security. It is also contended that it is uneconomic for a political body to borrow money, on the one hand, to finance expenditures and thereby incur an obligation to pay interest, while setting aside current tax revenues, on the other hand, to be invested and earn interest to meet future retirement system disbursements.

While the author finds the arguments in favor of advance funding more persuasive than the contrary ones, the reader is left to make his own choice. One of the contrary arguments occasionally offered is the example of the federal old-age benefit systems of the United States and Canada, which are financed on substantially a pay-as-you-go basis in practice. Comparing the financing of such systems with the financing of public employee retirement systems is hardly to the point. A federal old-age benefit system is essentially one under which, for social objectives, a portion of the nation's goods is transferred between the working population and those who

[3] *Blough* v. *Ekstrom,* 14 Ill, App. 2nd 153, 160, 144 N. E. 2nd 436, 440 (2nd Dist. 1957).

[4] In Canada, where a substantial percentage of the securities held by public employee retirement systems is in provincial and local bonds (see Table 5, p. 138), this argument can be extended to contend that an employer's unfunded system is as secure as one invested solely in the bonds of the employer.