Retirement Systems for Public Employees

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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 2

The Systems and Their Membership

RETIREMENT BENEFITS for public employees are generally provided through the vehicle of a formal retirement system. The system may be a unit of government with its own statutorily established controlling board or officer and administrative staff, or it may be merely a framework of laws and regulations, with no status as an agency or department. However it is constituted, participation in the benefits it provides is often referred to as *membership* in the system. This chapter discusses the foundations of such membership—the systems themselves, the persons eligible to join, and the financial commitments of the members.

RETIREMENT SYSTEMS

Many states and provinces have two large public employee retirement systems and a number of smaller ones. One of the large systems provides benefits for teachers through the twelfth grade level, sometimes including junior college staff, but generally excluding academic employees at the four-year college level. The other large system is for all other employees of the state or province itself, excluding any employees who might be included in small, specialized systems, such as those for the highway patrol or judges. Political subdivisions, such as the counties, municipalities, and water districts, are often eligible to join the state employees' system, making the system's benefits available to the local employees. Some local units may set up independent systems for their policemen, firefighters, or other employees. All told, a typical state or province might have 50 systems, many with their own controlling boards or committees, investment programs, and administrative personnel and equipment. Although some systems have common benefits imposed by state or provincial laws, such as systems for policemen and firefighters, many have selected their own benefit patterns, leading to a multiplicity of benefit structures.

While many states[1] come close to the pattern just described, there are also many variations. Some states have one large system covering all state employees and teachers and, on an optional basis, the employees of political subdivisions. Some states have statewide systems for policemen, or firefighters, or both. Some states provide a separate system from the state system for employees of political subdivisions. Many states provide coverage for their college and university professional staff with the Teachers Insurance and Annuity Association, a nonprofit insurance company which serves in many ways as a federal system for these employees.

Although there are many public employee retirement systems in existence, most covered employees are members of relatively large systems. For example, approximately half of the provincial, state, and local employees covered by retirement plans in the United States and Canada hold membership in systems of more than 50,000 members. Nearly 90 percent are in systems having at least 10,000 members. These large systems are generally administered at the state level for teachers, state employees, employees (other than teachers) of those political subdivisions which have elected to join the systems, or for combinations of these. Nearly all of the large

[1] The term "state" is used to encompass state or province, unless specifically noted to the contrary.

systems deal with more than one governmental unit; the term *conglomerate* will be used to describe such a system. This multiemployer characteristic distinguishes most large systems from the small systems, which are often administered by a single city, county, or other governmental unit.

Advantages of Conglomeration. There has been an increasing tendency for the conglomerate systems to grow and the smaller systems to be eliminated. This can have many salutary results to the taxpayer and to members:

Consolidation of administration with resulting reduced expense.

Better investment results because of the ability to afford investment counsel and because of greater diversification.

Spreading of the risk of adverse mortality experience.

Elimination of competition between systems for increasing benefits and consequent *leapfrogging,* where systems take turns catching and passing each other in benefits.

Elimination of the forfeiture or reduction of benefits for employees who change public employers within the system.[2]

Improved services to members because of a larger professional staff.

Sounder benefit design because of the legislature's freedom to limit its attention to a few systems.

A corollary to the last advantage listed above is that conglomeration imposes the full responsibility for a system's well-being upon the legislature. In contrast, some legislatures require cities and political subdivisions to set up their own systems and provide specified levels of benefits. Where this occurs, responsibility for proper financing of the benefits is often lacking. The legislature passes the job to the cities. The cities, especially those with already strained budgets, may do little to meet the costs of the programs but wait instead for the legislature to bail them out when the financing of prob-

[2] See p. 70.

lems become critical. Such a division of responsibility may thus mean no responsibility. This problem can be avoided by adopting a statewide program, leaving the legislature with full control of both benefits and financing.

Division of responsibility between the state and its political subdivisions can have another effect. By using a two-front attack, employees may exact benefit liberalizations which would otherwise be denied. The first appeal is to the local employers. Failing in this, the employees can go over the employers' heads to the legislature. Political considerations might override the employers' objections, regardless of their validity, and cause the legislature to require the payment of the improved benefits.

Disadvantages of Conglomeration. Favorable results do not necessarily attend all conglomerations. The arguments against conglomeration are those offered against any large organization—concentration of political power, the inertia of a bureaucratic administrative staff, and inflexibility. The last characteristic, inflexibility, applies not only to administration, where a large system must enforce rules which cannot fit all situations equally well, but also to the area of benefit structure. In a small system, the employer has the freedom to custom-design the plan of benefits to reflect the needs of the community. An example of the value of this right might occur in a retirement community drawing a significant portion of its employees from older persons who have retired from other occupations. A conventional benefit structure for such employees might prove both unduly expensive and inappropriate in the level of benefits provided.

As the fund amassed by a conglomerate system becomes very large, another disadvantage of conglomeration emerges. Managing the investments of a very large fund presents unique problems. Large blocks of securities are not easily bought or sold. Thus the large funds cannot be as agile in their security trading as the smaller funds. A survey of 634 private pension plans showed that among the majority whose funds are valued at market, those having assets between \$25 million and \$50 million fared substantially better in annual yield (5.3 percent) than those over $200 million (3.4 percent) during the 1965–1969 period.[3] Some large systems meet this problem by splitting their funds and investing the separate portions independently, often with independent money managers.

Inflexibility in a multiagency system can lead to a more subtle defect. This is best categorized by the word *antiselection,* an insurance term referring to the acquisition of insurance covering a worse-than-average risk with the expectation of financial gain at the expense of the insurer. A form of antiselection occurs where a unit participates in a public employee retirement system in order to provide its employees retirement benefits which are expected to cost more than the contributions of the unit and its members. Opportunities for such antiselection are great if all employers participating in a system pay the same percentage of salary, regardless of their inherent pension costs. Dramatic examples of antiselection have occurred in systems providing benefits related to the salary of each employee in his last year or two of employment. By raising employees' salaries shortly before their retirement, employers have increased those employees' retirement benefits out of proportion to the contributions which have been made to the system over the employees' working careers. Obviously this type of abuse can occur in most systems. In a system covering only one political unit, however, the unit will ultimately pay the price for this practice and may be motivated to avoid it. In a conglomerate system, if the practice occurs rarely, the cost will be spread over all employers, and no incentive is given the offending employer to refrain from the abuse.[4]

Political Conclusions. Regardless of the theoretical conclusions which might emerge from a balancing of the advantages and disadvantages, efforts to consolidate retirement

[3] *First Annual McGraw-Hill/Standard & Poor's/Intercapital Inc. Pension Fund Management Survey* (New York, 1971), Table VIII. The yields given include all capital gains, both realized and unrealized.

[4] See also p. 41 regarding legislation in New York State resulting from this practice.

systems into larger units may fall by the wayside because of political pressures. One of the greatest deterrents is the common phenomenon of empire building. Combining two or more systems into one results in fewer titles, fewer boards and fewer persons bearing the trappings of office, minimal as they may be. Unless the benefit structure can be improved by the merger, employee groups may object to consolidation due to the dilution of their ability to exert influence on the workings of the larger system. This type of opposition from both the systems' administrative staffs and members may thwart a proposed consolidation of systems, no matter how logical the consolidation might otherwise appear.

QUALIFYING FOR MEMBERSHIP

Mere employment by an employer does not necessarily entitle a person to participate in the employer's retirement system. Part-time, temporary, or seasonal employees may be excluded by statute or regulation. There may be a waiting period before participation in a retirement system can begin. Two or more systems may be provided by an employer for different occupational categories, or there may be a benefit differential by job within a single system. A former employee returning to work may be subject to special provisions. These prerequisites to membership vary between systems and are the subject of the next several subsections.

Employment Status. In many smaller systems, distinguishing eligible employees from those not eligible is quite straightforward. This is particularly true among systems covering policemen and firefighters, where a formal commissioning takes place, clearly defining the employee's status. In other relatively stable positions, such as clerical jobs, defining who is to be included in a system's coverage can also be easy. Problems arise in categorizing an employee who works in a job only needed during the summer, or as a janitor three hours each night, or on a fee basis, rather than as a direct employee. Where the system is small, problem cases such as these can be reviewed individually. If the system is meant to cover only full-time employees, the facts can be ascertained. If there is more than one criterion for membership, a judgment can be rendered in questionable situations. If a case comes up that was not anticipated when the governing rules and regulations were adopted, the rules and regulations may be changed to fit the new situation.

The larger systems, on the other hand, tend to have more formal participation requirements, because of their size and the diverse types of employment they cover. Generally, the rules are designed to grant eligibility only to those employees who work full-time or nearly so. For example, in the California Public Employees' Retirement System, membership is restricted to full-time positions and to half-time (or better) positions extending for more than one year. The administration of requirements of this sort often entails elaborate and detailed rulings to cover the great number of variations that will arise in special work situations.

Age or Service Requirements. A clear majority of public employees are in retirement systems granting immediate participation to employees in covered job classifications when they are hired.[5] In those systems which impose service requirements on the right of an employee to membership, 6 to 12 months must be served in most cases. In rare instances, the employee must also have attained a certain age, such as 30. In some systems, employees hired at advanced ages, such as over 60, are excluded from membership.

A waiting period may be justified on the grounds of administrative economy. One expense that the use of a wait-

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[5] Social Security Administration Research Reports No. 15 and 23: *State and Local Government Retirement Systems, 1965* and *Retirement Systems for Employees of State and Local Governments, 1966.* Approximately 75 percent of the employees covered in the Social Security Administration surveys were in systems providing immediate participation, regardless of age, in all areas of covered employment. The majority of the rest of the members were in systems having only maximum age restrictions. Less than 10 percent had minimum age or service requirements. A sampling of Canadian systems made by the author showed about 40 percent of the employees were in systems having immediate participation, about 25 percent in systems with only a maximum age restriction, and about 35 percent in systems with a minimum age or service requirement.

ing period avoids is that involved in setting up membership files for employees who terminate after short periods of service. A waiting period also eliminates the need to withhold and record employee contributions which are retained briefly and then returned. The more widely held viewpoint, however, is that there are significant advantages in having an employee begin to participate at the outset of his career. If an employee is covered as he comes on the payroll, any required contributions are deducted from his very first paycheck, causing him to become immediately aware of the cost of his participation in the system. In contrast, when an employee does not join a system until some time after he goes to work, the reduction in his take-home pay because of his required contribution can cause dissatisfaction. At the employer level, administration is simplified when each employee is brought into the system at his hiring date. Enrollment in the system can accompany the other personnel transactions taking place at hire, rather than requiring a special follow-up procedure when the waiting period is completed some time later. Furthermore, if the employer contribution to the system is set as a percentage of covered payroll, immediate participation simplifies the determination of the required aggregate contribution of a department and makes budget estimation easier. The employee also gains by immediate participation because of the increased benefit which results from the additional services credited to him.

Reemployment. Very commonly, an employee who transfers between participating employers maintains his membership in a system as if there were no termination of employment. Similarly, an employee rehired under the same system after a short break in service will retain credit for the service prior to his termination.

A somewhat more complex situation arises when an employee is rehired after an extended break in his covered employment. A common provision allows such an employee to reinstate previous credits by the repayment of any contributions he might have withdrawn. In a system where this is not allowed, an employee may nonetheless have the right to maintain his previously credited service under a vesting provision of the system.[6]

Another type of reemployment occurs among members who have previously retired. Of primary interest here is the effect the reemployment will have on the retirement benefit. This is discussed in the next chapter.[7]

EMPLOYEE CONTRIBUTIONS

Only about one employee out of every four covered by a private retirement plan in the United States is required to help pay for the plan by means of employee contributions.[8] This pattern is markedly different from the general rule among public employees. In fact, over 90 percent of the members of public employee retirement systems are required to make contributions.[9] This difference in practice displays a consistent adherence by most public employee retirement systems[10] to the philosophy that once prevailed in all plans—joint financing of retirement benefits.

Advantages of Contributory Systems. An early expression of this philosophy was given by the Commission on Pensions of New York City in 1918, as their grounds for recommending the adoption of contributory systems for that city:

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[6] See p. 68.

[7] See p. 49.

[8] U.S. Department of Labor: Bureau of Labor Statistics, *Labor Mobility and Private Pension Plans*, Bulletin No. 1407, 1964.

[9] Of 264 systems providing usable data in response to two surveys of the Social Security Administration in the United States and to the author's survey of Canadian systems, 251 systems were contributory. See Social Security Administration Research Reports No. 15 and 23: *State and Local Government Retirement Systems, 1965* and *Retirement Systems for Employees of State and Local Governments, 1966.*

[10] A notable exception is found in the state of New York. Under a 1960 amendment to the governing laws of the New York Public Employees' Retirement System, the state and all participating political subdivisions which have so elected make additional contributions to replace all or a portion of their employees' contributions. This feature of the system, which is referred to in the law as "pensions-for-increased-take-home-pay," has converted the New York system from a fully contributory to a noncontributory system for the majority of its members. In similar fashion, the New York State Teachers' Retirement System and other systems in New York have become largely noncontributory.

A system in which both parties contribute is proposed because . . . of the sense of mutual responsibility thereby fostered for the provision of benefits which will be equitable and advantageous to both parties. . . . Through the responsibilities thereby developed for the provision and retention of benefits equitable to both parties, there would be a natural check on overliberal interpretation and legalized liberalization of the provisions which would make the system unduly costly to either party.[11]

A restatement of this philosophy with a slightly different twist and the advantage of 50 additional years of experience is found in succinct comments made by the Legislative Retirement Study Commission in its report to the 1971 legislative session of the state of Minnesota. Among several other guidelines for the legislature, the Commission includes the following statement of principle:

Governmental employer support of normal level pension costs should not exceed equal matching of the employee's contribution to his pension, except as to certain law enforcement and safety employees. To provide a greater share of the benefits at governmental expense tempts employees to strive for extra benefits and marginal benefits because the cost to the employee is small. Pensions should not become "hidden extra salary."[12]

These statements embrace the concept that the costs of benefit improvements should be shared between the parties. This in turn necessitates cost determinations which will provide a basis for this sharing. Within this framework, a contributory system can provide retirement benefits in an environment of responsible management where the costs are known and shared.[13] It will be noted that this concept is not always conspicuously present. It will also be noted, incidentally, that the goals of responsible management can be met in a noncontributory system if the costs (after having been appropriately

[11] Commission on Pensions, *Report on the Pension Funds of the City of New York* (New York, 1918), pp. 15–16.

[12] Legislative Retirement Study Commission, *Report to the 1971 Legislative Session of the State of Minnesota* (St. Paul, 1971), p. 12.

[13] The information needed for the costs to be known will be discussed in Chapter 5.

determined and disclosed) are recognized by both the employer and employees as alternatives to similar expenditures in direct payroll. This approach involves pricing pension costs in cents per hour, an idea that is widely accepted in collective bargaining in the private sector.

From the employee's viewpoint, a strong argument favoring his making contributions is the leverage it gives him in enforcing his rights to benefits and in insisting on adequate employer contributions. The employee who makes his contribution has a moral, if not a legal, right to expect the employer to do likewise. For the same reason, the employee may have stronger cause to believe that the retirement program will be maintained than if he were not making contributions. This concept was stated by President Franklin D. Roosevelt in a reference to the United States social security program:

> We put those payroll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions and their unemployment benefits. With those taxes in there, no damn politician can ever scrap my social security program.[14]

Disadvantages of Contributory Systems. Probably the greatest of the disadvantages of contributory systems in the United States is that contributions made by the employee must be paid from after-tax dollars. The employee must include contributions deducted from his salary in his taxable income, even though they are locked into the fund and he does not have use of them while he remains at work. This disadvantage is offset to a slight extent after retirement, when a portion of his pension is tax free. However, this offset is of no value to many retired employees, since it is common for a retired employee's personal exemptions and deductions to exceed his taxable income. The importance of these tax considerations in plan design is difficult to measure. It is interesting to note, however, that in Canada, where salary deductions for contributions to registered pension plans are

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[14] Arthur M. Schlesinger, Jr., *The Coming of the New Deal* (Boston: 1957), p. 308.

tax-deductible, contributory plans are much more common, covering over 60 percent of employees under retirement plans in the private sector.[15]

Contributory plans have other drawbacks besides adverse tax consequences. A contributory plan is more difficult and expensive to administer. Employee contributions are inconsistent with the growing recognition of pensions as deferred compensation, rather than as joint savings programs. A contributory plan may inhibit good employee relations, particularly among those who are many years from retirement. For the younger employee, the required contribution may be looked upon as an onerous burden to be met at a time in his career when he is least able to afford it. Finally, if a given level of employer and employee contributions is set aside under a contributory plan, that same level, contributed solely by the employer, will generally produce greater benefits. This is partially due to savings in expense, but in larger part is due to the avoidance of refunds to employees upon termination of service prior to retirement.[16]

Level of Contributions. Under a contributory system, the employee normally contributes a stated portion of his monthly salary—typically, 4 to 6 percent. This contribution is a form of savings deposit, since eventually it will be returned in the form of retirement, death, or disability benefits, or refunded upon termination of employment. In this respect, public employee retirement systems differ from social security where the contributions are, in effect, taxes levied to provide funds to pay benefits to current beneficiaries. The employee's obligation is usually expressed as a percentage of all, or a part of, his earnings. A fixed-dollar contribution is seldom used. This reflects the correlation between contributions and benefits, since the latter are also nearly always related to salary. The actual amount an employee contributes varies considerably among the different public employee

[15] Statistics Canada, *Pension Plans in Canada, 1970* (Ottawa, 1972).

[16] This cost disadvantage of contributory plans is diminished or eliminated to the extent that employees forfeit vested benefits upon termination of employment in order to collect their accumulated contributions. See p. 69.

retirement systems. This variance is due not only to differences in the contribution rates themselves, but also to differences in the salary bases to which the rates are applied.

The majority of public employee systems express the employee contribution in terms of a percentage, or a range of percentages, of the member's total basic earnings, exclusive of overtime pay or any other special allowances. For the purpose of administering payrolls, this method is probably the most economical and has all the other advantages of simplicity. Nevertheless, a significant number of systems require contributions on earnings up to a specified amount only. Common limits are $3,600, $4,800, $6,000, and $7,500. The lowest two of these limits reflect the United States social security wage bases during different periods. A variation on this pattern occurs in many systems, where contributions are made at a specified rate on annual earnings up to similar dollar limits, and then at a higher rate on all earnings in excess of such limits.

Although typical employee contribution rates might be 4 to 6 percent of earnings, actual contribution rates vary over a much wider range. In a number of systems the employee contribution rates vary by a member's sex, the age at which he enters the plan, and sometimes the type of work he does. The percentages of salary contributed by members of a system of this type are given in Table 1. The reasons for the variation in contributions by age and sex in this table are

TABLE 1
Employee Contribution Rates, New Jersey Public Employees' Retirement System

Age at Entry	*Percentage of Salary*	
	Male	*Female*
25	4.91	5.51
30	5.19	5.85
35	5.59	6.30
40	6.04	6.81
45	6.55	7.39
50	7.12	8.02
55	7.84	8.83

related to the benefits provided under the system.[17] In most of the systems with this type of contribution schedule, member contributions, accumulated to retirement, are designed to provide a specified portion (often one half) of the total retirement benefit.

Interest Credited on Employee Contributions. In the type of system just mentioned, where there is a direct relationship between the accumulated employee contributions and the retirement benefit, vital issues are involved in determining the rate of crediting interest on the accumulated contributions and the rate basis used for converting these accumulated contributions into annuities at retirement.[18] Extended litigation involving these issues has occurred in some systems, an indication of the importance of proper treatment of employee contributions in public employee retirement systems.

An important consideration in determining the rate of interest to be credited in accumulating employee contributions is whether employee contributions are to be viewed as savings of the employee or as part of his price for the retirement benefit. The employee who terminates before retirement has made his contributions as a form of forced savings. While the same might be said for the employee who remains in employment until he retires, his savings then serve the primary purpose of providing a contribution towards the total cost of his retirement benefit.

It is significant, in this regard, that employee contributions in public employee retirement systems are nearly always a condition of employment: All new employees must join the system and make the required contributions when they become eligible. If employee contributions are regarded as a form of forced savings, an employee might well contend in equity that his contributions should be credited with interest at a rate comparable to that which they would receive in an equally safe investment of his own choosing.

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17 See p. 39.

18 See p. 41 regarding annuity conversion rates.

In practice, a wide spectrum of philosophies appear to exist in the crediting of interest on employee contributions. At one extreme are systems where an employee is not only paid no interest but forfeits all of his contributions if he should terminate early in his career. This type of provision, where it exists, is usually found in a system covering policemen or firefighters.

Not quite so adverse to the employee, but confiscatory nonetheless, are systems which credit no interest on the contributions of terminating employees. There are also systems which pay only a nominal rate of interest, such as 2 or 3 percent, on the accumulated contributions. In these systems, the employee who terminates is, in effect, making a contribution towards the pension of his fellow workers, in the amount of the foregone additional interest on his contributions.

Many systems, particularly the larger ones, credit interest on the accumulated contributions of each member at a rate approximately equal to the earnings rate of the system as a whole. This technique puts the employee in an equitable position with the employer as to the earnings on the funds contributed by the respective parties. In a well-managed system, the interest so credited will compare favorably with that provided by other savings media, such as banks, savings bonds, and life insurance.