RETIREMENT SYSTEMS FOR PUBLIC EMPLOYEES
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Retirement Systems for Public Employees

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PUBLIC EMPLOYEE retirement systems are in a constant state of flux. Rare is the system that has not had some benefit change over any recent five-year period. As a result of innumerable modifications of individual systems, patterns of change are developing in benefit structure, in financing, and in other areas affecting the systems. As these patterns are emerging, so also are the controversial issues that many of them are bringing. Some of these issues are discussed in this chapter.

BENEFITS

The benefit area presents a number of major issues of current concern. Background material in this area is found in chapters 2, 3, and 4. It will be noted that none of the matters considered in this portion of the chapter is completely divorced from financing questions, even though the primary emphasis is on benefits.

Collective Bargaining. The process of collective bargaining has had an increasing effect on salaries and fringe benefits in nonfederal government employment. The formality of the
negotiation procedure has advantages on both sides of the table: to labor by improving its clout, and to management by narrowing the field of those who represent the working force, with their possibly conflicting viewpoints, to whom management must listen. When an agreement is reached for a new basis of wages and benefits, a vote among the employees gives some assurance of satisfaction with the terms of the agreement. Nevertheless, the very factors which make collective bargaining advantageous to labor make it disadvantageous to the employer, who finds his negotiating position weakened to the same degree as labor's is strengthened. Moreover, the process entails hazards of specific application in the retirement area.

As benefits grow, the burden on current taxpayers of funding systems properly may prove unacceptable. This potential certainly exists in some systems covering policemen and firefighters, where the required employer contribution rates approach an amount equal to one half of payroll. Yet employees with greater bargaining strength have the ability to enforce demands for increased benefits. One of the results of such a collision of interest is that actuarial assumptions in a nominally funded system might be chosen so as to relieve the pressure. When current costs are thus understated, bargaining becomes a farce, with a false price tag attached to the benefit package. Higher benefits are granted than can be afforded, at least as measured by the current employer contribution rate. As the contingencies assumed prove to be more adverse than the assumptions, costs will climb and the extra burden will be passed on to future taxpayers. An even worse situation is where the system is unfunded and the entire cost is deferred, to be paid by future generations. In either case public employee retirement systems are in a unique and vulnerable position. Labor wants a certain increase in compensation. Management is willing to pay only a portion of labor's request currently. The difference can be compromised by making future taxpayers pay it, simply by failing to fund properly now.

**Ratchet Effect.** A ratchet is a wheel that can move in one
direction only. The benefits of many public employee retirement systems have similar characteristics. Rules of law in some jurisdictions provide that an employee's benefits can never be lower than those in effect when he is hired. Moreover, any improvement in benefits sets a new floor below which the benefit level can never fall for employees then at work. Where this rule obtains, great care must be exercised in designing benefit improvements. If an excessive benefit is granted, it either is permanent or can be eliminated only for new employees; current employees must be given its advantages so long as they are covered by the system.

Special Benefits. Public employee retirement systems are prime targets for special benefits affecting only a small number of people. Such benefits may be granted by private bills specifically designating a person to be favored. Another technique for the same purpose is to grant special benefits to a class of employees which includes only one person or a small group of people.

A more expensive abuse is the modification of a benefit structure to provide a particular advantage to a specific individual, but in such a way that the same benefits are given to any others who happen to be in the same category. An example of this occurred in a southwestern state when a legislator asked for a change in the optional benefit he had elected under the public system of which he was a member. His request was not granted, since it would have inflicted financial hardship on the system and unfairly favored him over other employees. The legislator then forced the system to accede to his request by the simple expedient of pushing a bill to that effect through the legislature. Since the bill required the same treatment of all persons in his circumstances, others have been able to take advantage of the change in the benefits, all at an additional cost to the taxpayers.

Public employee retirement systems are particularly susceptible to this type of abuse. A large payment in cash to an individual may gain unfavorable publicity because of the evidence of immediate financial advantage. On the other hand, an equivalent windfall in retirement benefits may not
require a substantial current disbursement and is less likely to reap adverse publicity. Moreover, budgetary constraints may not limit a special retirement benefit, whereas a benefit involving current disbursements might be out of the question. A particular form of special treatment which appears to prevail in many areas is the provision of disproportionate retirement benefits for legislators and other elected officials. If their retirement benefits are computed using a formula significantly more favorable than that applicable to other public employees, the cynical conclusion must be that political considerations prohibit their taking other forms of compensation which would be more immediately evident to the voter.

**Employee Contributions.** Retirement systems where the employees are required to contribute have one fundamental advantage: Since the employers and employees are partners in paying for the benefits, proposals for benefit changes having excessive costs relative to their value tend to be passed by, while those of real importance to the employees are instituted and justified by the employees' willingness to pay for part of the cost. This concept presupposes the benefit improvements which require increases in employer contribution rates automatically bring increases in employee contribution rates. This is not always the case. One of the deterrents to increases in employee contribution rates in the United States is the adverse federal income tax effect. Since the employee contribution is paid from after-tax salary, there is a strong disincentive to increasing the employee contribution rate. In fact, because of the personal tax saving, an employee's take-home pay can be increased by eliminating the required employee contribution, even if the employer reduces the employee's salary by the same amount and contributes the difference as an additional employer contribution. This tax bias in favor of noncontributory systems would be eliminated if the income tax laws of the United States were to be changed to allow employees to deduct contributions to retirement plans from their taxable incomes, as can their Canadian counterparts.
An alternative to the use of employee contributions as a measure of employee acceptance of benefit improvements is to view the commitment for a retirement program as an intrinsic payroll cost. The price tag attached to a benefit improvement is then expressed in cents per hour or dollars per year, and is considered a part of the total compensation package. An improvement in retirement benefits having a certain current cost is made available by reducing wages correspondingly, or by offsetting the cost against an increase in wages which would otherwise be payable. Obviously such a concept works only if the ultimate costs are properly translated to current payroll amounts.

Younger Normal Retirement. Chapter 5 contained a discussion of the cost of reducing the age at which an employee can retire without reduction in accrued benefits. In general, even if the average age of retirement is reduced only one or two years, the additional cost to a system can be quite significant.

In addition to the costs involved, the trend towards younger ages at normal retirement has other implications. From a sociological viewpoint, some persons find more satisfaction in work than in the leisure of retirement, particularly when they are in good health. When earlier retirement is mandatory, members of this group will be dissatisfied. Where retirement occurs at an early age, the employee may take another job and thus frustrate any effort to remove him from the labor force to make a job for a younger person. Moreover, the retirement allowance being received by the retiree may put him at an unfair advantage in obtaining a job, with adverse effects on wages in general. When such a person is receiving retirement benefits from a public employee retirement system, public acceptance of the system as a whole may suffer.

Postretirement Adjustment. The continual erosion in the purchasing power of the dollar has focused attention on post-retirement adjustments. The long term worth of the various approaches to making adjustments will be tested over the
years. In one respect, widespread use of postretirement adjustment may tend to reduce resistance to inflation because so many people will be insulated from its effect. Moreover the additional consumer funds created with increased retirement allowances may be inflationary in themselves, arising as they do without a corresponding increase in the production of consumer goods.

Postretirement adjustments may also exacerbate the problems of financing retirement systems. A series of minor increases in retirement allowances can prove very expensive in the long run, as the compounding of the increases causes the total benefits to mount. For example, based on common assumptions as to mortality and interest earnings, the value of a level pension to a man retiring at age 65 is increased by over 25 percent if the pension is to be subject to a 3 percent annual increment. For a woman at the same age, the increase of value is 30 percent. The effect is more pronounced for retirements at younger ages: At age 55, the cost increases over 35 percent for a man and over 40 percent for a woman.

Despite the obvious advantages of postretirement adjustments on an automatic, continuing basis, opposition to such a procedure can be evoked from both management and labor representatives. Management's objections include the fear that the automatically increased benefits will serve as a jumping off point for demands for additional benefits, without adequate recognition being given by labor to the fact that an automatic increase in benefits represents a benefit improvement. Labor's objections include just the converse: Management may rest on its laurels, failing to recognize legitimate needs for increases beyond the automatic increase, such as when active employees receive benefit improvements or when increases in living standards outstrip the automatic increases.

Vesting. In both public and private systems, vesting and its availability are issues of continuing interest and of some controversy. Balanced against each other are the cost of vesting and the social desirability of generous vesting provisions.
One factor working to reduce the cost in public employee retirement systems is conditional vesting, vesting which can be and often is forfeited by the withdrawal of the accumulated employee contributions upon termination of employment. In the United States, over 90 percent of the nonfederal public employees covered by retirement systems make contributions under their systems; the comparable percentage for private plans is about 25 percent. Since conditional vesting exists only in contributory plans and can greatly reduce the cost of vesting, cost as a deterrent to vesting is less important in public employee retirement systems than in private plans in the United States. This could change however if a trend should develop to abandon conditional vesting in contributory programs. One way this might happen would be by voluntary amendment of benefit provisions to let terminating employees withdraw their contributions without forfeiting all of their vested benefits. Alternatively, legislation might be enacted preventing a vested employee from withdrawing his contributions; legislation of this sort is in effect in much of Canada. However brought about, such a change would be of great significance, both in increasing the costs of public employee retirement systems and in protecting their members from shortsightedly thwarting the benefit goals designed into the systems.

Benefits can also be preserved by means of reciprocal agreements between systems for the maintenance of credit for employees who transfer between the systems. However even if an employee's benefits earned with several employers are fully vested in this manner, he usually receives less in benefits than if he had stayed with one employer, owing to the tendency for the salary basis upon which his benefits are computed to be smaller with earlier employers. Although solutions to this problem have been hypothesized, the problem remains largely unsolved in practice. Professionals and other skilled employees are increasingly in demand in public employment; attractive opportunities and effective utilization of such employees will occur only if employee mobility
is not discouraged. Satisfactory reciprocity arrangements could eliminate a major source of discouragement.

FINANCING AND INVESTMENT

The needs of state, provincial, and local governments for funds seem to be ever increasing. With limited resources, governments are constantly subjecting expenditures to squeezes. Public employee retirement systems are excellent starting points for those striving to achieve reduction in current expenditures. The factors which must be considered before any such reduction occurs were discussed in some detail in chapters 5, 6, and 7. These factors will be summarized below and augmented by related observations.

The Need to Know Retirement Costs. The ultimate cost of a retirement program is determined by actual benefit disbursements. However it is imperative that these costs be estimated before the actual disbursements are made. The cost commitment must be known when a system is established and each time thereafter that the benefit structure is modified. Further, if a wise decision is to be made about the method for meeting the costs of a retirement program, the magnitude and timing of those costs must be known.

Projections of the disbursements provide valuable information for this purpose. They lack, however, two of the features of an actuarial cost method:

The ability to associate benefit improvements with current salaries, to give a measure of the worth of the improvements in current dollars;

The simplicity and ease of comparison which a level cost basis provides.

A projected cost thus goes only part way in providing the information needed for sound decisions about creating, amending, or financing a retirement system; an actuarial method of measuring the costs is required to obtain the full story. An actuarial cost method can establish prices for im-
improvements in retirement benefits comparable to those for increases in wages and other employee compensation. These prices, in turn, should be prerequisites to negotiating benefit changes and to legislative decision making.

The taxpayer, who must ultimately pay the cost, has the right to know the cost when the commitment is being made. Perhaps a form of “truth in labeling” legislation is needed for retirement system costs. Surely taxpayers deserve the same consideration and protection as consumers or stockholders get.

**Funding.** If all of the elements of cost are presented to the legislative authority and are understood, a rational decision can be made as to the amount the employer is to contribute under the retirement system. The basic arguments which might then sway the decision in favor of funding—building up a fund by paying currently accruing actuarial costs—are the following:

Funding treats the cost of a retirement program as it really is: a payroll cost to be met currently just as are all other payroll costs, rather than to be deferred for payment by some future generation of taxpayers.

The payments for funding the benefits accruing for current employees develop a pool of assets which provides assurance for those employees that their benefits will be paid when due.

Funding reduces the amount of taxes to be levied, because part of the pension disbursements are met by earnings on the investments.

The first of these arguments is probably the most important. A slight restatement of it is that funding is a form of discipline. The requirement that current payroll costs be met currently avoids the expensive procrastination and wishful thinking that failure to fund can entail. Payments may be postponed under the delusion that it will be easier to pay the needed costs in the future, particularly when the problem of such future payments will be the responsibility of someone else. This approach may be politically expedient but can only
create an onerous retirement system commitment for future generations.

Rate of Employer Contributions. The many variables affecting employer costs have created a wide spread in the rates of employer contributions currently in effect in the many public employee retirement systems in the United States and Canada. For example, even where the data for all of the systems of each state are combined, the employer contribution rates in a recent year ranged from a low in one state of less than 1 percent of payroll to a high in another state of nearly 15 percent. In that year, 1969, the average employer contribution for the state and local systems of the United States as a whole was 7.3 percent of salary. This rate is on an upswing since the comparable figure in 1961 was 6.5 percent. The significance of the financial commitment for public employee retirement systems can also be measured by the fact that the 1969 contribution represented 3.5 percent of the total state and local budgets.

The percentages given in the previous paragraph are based on actual employer contributions for retirement purposes. To the extent some systems are not meeting the costs of benefits currently accruing, the statistics tend to understate the true costs, which include the increase in the value of the systems' unfunded commitments. This understatement will cause future contribution rates to increase as present employees reach retirement and start receiving benefits.

Another cause of increasing employer contribution rates is the continuing liberalization of benefits. Many outcroppings of this are evident in the form of pressures for larger and earlier retirement benefits, expanded disability and survivors' benefits, increased vesting, and reduction or elimination of employee contributions. Moreover, the rapid increases in payrolls of persons covered by public employee retirement systems, to the extent that they continue in the future, will also bring higher benefits and further increase future required employer contributions.

Economic Implications. Much has been written in recent years regarding the impact of pension funds upon the overall
economy. They are taking their place beside banks, savings institutions, mutual funds, and life insurance companies as major influences on the capital market. Despite the rapid increase in private pension plans in the last two decades, the older and supposedly more mature public employee retirement systems are more than holding their own in this area. In fact, in the 15-year period from 1950 to 1965, the net capital contributions of the public employee retirement systems to the capital market, when compared with the contribution of all retirement plans in the United States (excluding social security), grew from less than 18 percent to better than 26 percent.\(^1\)

The mushrooming of public employee retirement systems can be illustrated most vividly by the figures in Table 6, which show the growth of certain financial data of all such retirement systems in the United States over a 13-year period

<table>
<thead>
<tr>
<th>Year</th>
<th>Income (billions)</th>
<th>Expenditures (billions)</th>
<th>Assets (billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1957</td>
<td>$2.5</td>
<td>$1.0</td>
<td>$12.8</td>
</tr>
<tr>
<td>1962</td>
<td>4.0</td>
<td>1.6</td>
<td>23.3</td>
</tr>
<tr>
<td>1967</td>
<td>6.6</td>
<td>2.7</td>
<td>39.3</td>
</tr>
<tr>
<td>1970</td>
<td>9.8</td>
<td>3.7</td>
<td>54.9</td>
</tr>
</tbody>
</table>

Source: U.S. Bureau of Census reports.

What does the future hold? The prognosis is for more of the same—more covered employees, more contributions, and more money in the funds. The growth rate in public employment is such as to indicate a doubling of the covered membership in public employee retirement systems in a 15-year period. A 1966 study by Daniel M. Holland, under the sponsorship of the National Bureau of Economic Research, projected total assets of U.S. public employee retirement systems in 1975 of $75 billion and in 1979 of over $100 billion.

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\(^1\)Private and Public Pension Plans in the United States (New York: Institute of Life Insurance, 1967), Table 8.
billion. Based upon the experience since the publication of his figures, even these rates of growth appear low. What is perhaps even more striking about Holland's projections is the effect he estimates public employee retirement systems will have on the capital markets in the future—the net amount which they will have for investment:

... state and local funds are projected to be such powerful accumulators that by 1981 they will be buying more assets each year than industrial plans. ... this result is uncertain, for the projections of this sector over the later years are subject to ... error. Not open to real doubt, however, is the likelihood that state and local funds and their net purchases will continue to grow in relative importance.²

The size and growth potential of these funds must be given careful attention. The citizens of the United States and Canada have long been conditioned to their governments' playing major roles in economic matters, but the unique characteristics of pension funds sets them apart from most other forms of governmental expenditure. In a sense, this money is held in trust for their beneficiaries, yet they are, in another sense, at the immediate disposal of the legislative authorities governing them. Moreover, the management of these funds requires sophisticated investment skills, opening up a substantially new role for government. As the funds grow, and larger shares of the assets are held in common stocks, the proper role of government as a significant shareholder in private corporations will need to be considered most carefully.³

GENERAL

Some of the issues facing those responsible for public employee retirement systems are of a broad scope, affecting

benefit structure, financing and all other aspects of the public retirement scene. The balance of this chapter will be devoted to three of these.

Social Security. In the United States, public employees at both the federal and nonfederal levels make up the only large group not covered under either social security or the Railroad Retirement Act. At the state and local level, social security coverage is dependent on an interaction of federal enablement and local acceptance by referendum voting. As a result, about two thirds of the state and local employees are covered by social security and about one third are not. The units covered change occasionally, as new groups join and others leave.

A major factor causing groups to abandon social security coverage and others not to participate is the cost of the program. Comparisons have been prepared which purport to demonstrate that comparable retirement benefits could be obtained more cheaply by making arrangements outside social security. Analysis of these comparisons requires a high level of sophistication, because of the importance of the assumptions used in the comparisons and the complex nature of the social security program. The choice of interest rate to be used in the comparison is critical, since a rate too low will underestimate the benefits that can be accrued by accumulating money in a local fund rather than making equivalent contributions under social security. Incomplete comparisons can result from failure to include the ancillary benefits (e.g., death and disability) of the social security program or to recognize the likely growth in social security benefits from their present level because of increases in wage and price levels. To emphasize the importance of the latter point, Wilbur D. Mills, chairman of the House Committee on Ways and Means, projects the maximum benefits for a worker and his spouse in the year 2000 to be about $1,200 a month, as compared with a corresponding maximum monthly benefit of $443 in 1971. From a speech prepared for delivery July 28, 1971, to the National Conference of State Social Security Administrators.
payable for persons who work for a lifetime under the law’s maximum salary provisions.

Nevertheless, some systems may be able to reduce the total employer and employee financial commitment by providing their members benefits similar to those the members lose by not being covered by social security. The savings in cost can arise because of:

Artificially high benefits paid under social security for residual or supplementary credits earned by members not currently covered by social security;

Individual characteristics of the group which would make it more likely to pay more in aggregate in social security taxes than would be received in benefits;

Inability to match the automatic vesting and reciprocity features of social security.

When a group withdraws from social security, many of its members are “fully insured” under social security because of their past covered service. They thus retain rights to receive some social security benefits. Those who have not accrued such rights may still earn partial social security coverage by moonlighting\(^5\) or by switching to covered employment after retiring from a public system. The latter route to social security benefits among employees otherwise not covered is a relatively simple one to follow for the many employees, especially policemen and firefighters, who can retire from public employment before age 60. No matter how a person earns partial social security coverage, his average wages and therefore his benefits for social security purposes are smaller than they would be if all his employment had been under social security. Even in this respect, though, he gets favorable treatment under social security. This is because social security benefits for low-paid employees are equal to a relatively high percentage of covered earnings. An employee who switches to covered employment after retiring from a public employee retirement system also benefits by the social secu-

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\(^5\) See footnote 15, p. 75.
rity provision allowing a dropout of the five years of his lowest earnings in the calculation of his benefits. This dropout prevents his average wage from being dragged down by five of his years without earnings under social security. In many ways, then, employees not covered by social security may use the provisions of social security law to their advantage. The contributions saved by not being under social security may be translated into better benefits in the local system covering the employees. If so, it is entirely possible for many such employees to obtain a greater overall benefit than if their public employment were covered by social security, although the advantages of this approach will not be uniformly spread among all such employees.

Self-insurance might also be cheaper than social security in a predominantly young group, very few of whose members will receive the advantages of benefits in the near future after minimal contributions. Similarly, a group made up primarily of women teachers is sometimes said to receive less in benefits than their social security taxes buy because the survivorship benefits are of essentially no value to the single women, or else the married women are already entitled to substantial benefits from their husbands' social security. However this cannot be categorically stated, since women at retirement also get more for their money than men, due to their longer life expectancy. Moreover, any comparison of the cost advantages of an individual group may be valid only temporarily, due both to changes in the group's average age and service characteristics and to changes in the social security laws which might alter the comparisons for any particular group.

Since social security covers most of the working population of the United States, the accrued benefits of any individual continue to grow as he moves from job to job in covered employment. However, when a person moves to a job that is not covered by social security, this accrual stops growing and may well decline. A program in a public employee retirement system which attempts to emulate social security will have a similar failing for employees transferring out of the system without vested benefits. However the loss of benefits is
much more likely in a public system, because change of employment so often moves a person outside the particular system but so rarely moves a person covered by social security to a job not covered. For this reason, the system's costs would tend to be lower than social security's because of the forfeited benefits of those employees who do not remain in the system long enough to acquire vested benefits. With the widespread attention being focused upon vesting and portability of benefits, this saving in cost would seem of questionable value when balanced against the reduced retirement benefits which bring it about. In fact, the social advantages of universal social security coverage would seem to outweigh any of the financial advantages which might result from keeping public employees out of social security. Until federal employees are also covered, however, this last argument on philosophical grounds would seem idle.

A strong incentive to include all employees under social security would occur if a portion of the cost of social security were borne out of general tax revenues. Proposals to this effect have been discussed from time to time, with the general concept being that one third of the cost would be carried by the government through general tax revenues, the balance being shared in equal proportion by employers and employees. If this approach were adopted, the employee who is not covered by social security would nevertheless be contributing through his income tax payments to the financing of its benefits. This would certainly encourage public employee groups to join social security or stay in, by making the benefits to be received much more attractive when compared to the employer and employee contributions to be paid.\(^6\)

**Conglomerates.** The advantages enjoyed by larger systems, as noted in Chapter 2,\(^7\) have led to the gradual centralizing of systems within states and provinces. Small systems

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\(^7\) See p. 20.
tend to be combined into one or two larger systems. This has been particularly true for policemen and firefighters, for whom a number of states have replaced individual systems with combined statewide systems. A common advantage of such a change is the establishment of a level contribution rate statewide, one which does not increase or decrease as freely as corresponding rates do in smaller systems. The change may also result in the state or province taking a financial part in meeting the obligations of the system, the legislature thus being responsible for meeting part of the costs of benefits which it has often caused to exist.

Probably the greatest problem of the very large systems is their concentration of political power. Each of them invests millions of dollars each month and has the potential of bringing an increasingly large bloc of voters (their active and retired participants) to bear on issues. The emerging of these systems as political forces is too recent to be analyzed in any depth, but their performance bears watching in the next several years.

Public Pension Commissions. As the task of legislative management of public employee retirement systems becomes more complex, many states have established watchdog committees to advise on public employee pension matters. These are generally branches of the legislatures. Their function is to review the activities of the various systems within their jurisdictions and screen legislative proposals.

The decisions of a public pension commission must have credibility and be respected in the legislature, if the commission is to be effective. Ideally, a legislature will not consider a bill affecting public employee pensions unless the measure has been reviewed by the pension commission. For such a review to be meaningful, the commission must require that the cost of all proposals be obtained and made public. Further, the commission should have the experience and sophistication to be able to look behind each bill and seek out additional data where the bill has far-reaching implications. The report to the legislature on any measure should bring out all of the issues involved in a clear fashion so that all legislators,
including those who are not skilled in pension matters, will be able to make a reasoned judgment. If the pension commission has gained the respect of the legislature, the legislature will refuse to act without such guidelines and ill-considered legislation will be thwarted.