America's Public Retirement Plans: Stresses in the System

"The long-term economic health of the United States is threatened by $53 trillion in government debts and liabilities that start to come due in four years when baby boomers begin to retire. . . The $53 trillion is what federal, state and local governments need immediately—stashed away, earning interest, beyond the $3 trillion taxes collected last year—to repay debts and honor future benefits promised under Medicare, Social Security and government pensions."

USA Today, October 2004

"The public retirement system community has experienced a confluence of events that is probably unprecedented. . . . Pension funds went from a $245 billion over-funded condition in 2000 to a $366 billion shortfall in 2003."

National Association of State Retirement Administrators, December 2003 and Wilshire Associates, March 2004

"The Pension Benefit Guaranty Corporation, the federal organization that protects the pensions of 44 million American workers, [announced] that its deficit reached a record $11.2 billion last year and warned that it is continuing to hemorrhage money."

The Baltimore [Maryland] Sun, January 2004

"Tens of millions of Americans are seriously under prepared to meet their financial needs in retirement. As many as 40 percent of Americans have saved almost nothing for retirement."

National Retirement Planning Coalition, February 2004

"In 2008--just four years from now--the first cohort of the baby-boom generation will reach 62, the earliest age at which Social Security retirement benefits may be claimed and the age at which about half of prospective beneficiaries choose to retire; in 2011, these individuals will reach 65 and will thus be eligible for Medicare. At that time, under the intermediate assumptions of the Old Age Survivor and Disability Insurance (OASDI) trustees, there will still be more than three covered workers for each OASDI beneficiary; by 2025, this ratio is projected to be down to two and a quarter. . . . If this fundamental change in the age distribution materializes, we will eventually have no choice but to make significant structural adjustments in the major retirement programs."

Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Committee on the Budget, U.S. House of Representatives, February 2004

Introduction

Few other topics generate more spirited discourse and disagreement among policymakers than a discussion on devising a comprehensive retirement system to account for the huge number of "baby boomers" scheduled to retire in the next few years.[1] The primary goal of this retirement system would be to sustain participants with adequate benefits for the duration of their retirement years. However, a spate of economic setbacks in the past few years, such as the sputtering stock market, rising deficits at the federal and state levels, rising fears over terror attacks, mounting corporate scandals affecting consumer confidence, dwindling corporate profits resulting in severe cutbacks and a jobless economic recovery, continues to cause stresses in the retirement plans of millions of Americans. Hence, it probably is not a stretch to maintain that an increasing number of Americans, particularly those nearing retirement age, remain extremely apprehensive about their retirement situation in the years ahead.

Financial planners often recommend the "three-legged stool" concept in planning for retirement. Each leg of the stool is supposed to represent a source of income in retirement, and the goal is to cumulatively attain a standard of living at least comparable to the one experienced prior to retirement. In this analysis, if the first leg of the stool is Social Security income, the other two legs of the stool refer to personal savings and retirement or pension system income. Unfortunately, a close review of national financial and demographic trends reveals that all three legs of this metaphorical retirement stool remain wobbly, a development that threatens to seriously jeopardize the retirement plans of a majority of Americans.

Any discussion of a comprehensive retirement system inevitably brings up the issue of the long-term solvency of Social Security, particularly in the context of the growing importance of Social Security payments to retirees. For some years now, analysts have stressed that policymakers need to initiate concrete steps to prepare for the "graying" of America and the increased number of retirees. The number of people in the United States over 65 is expected to increase significantly by 2030; specifically, that age group is forecast to grow from about 13 percent of the total population in 2000 to 20 percent in 2030 and to remain above 20 percent for at least several decades thereafter.[2] Consequently, a great deal of attention has been directed toward revamping Social Security, which, since its inception in 1935, has become the country's largest income-maintenance program. Social Security payments are essential for most retirees; these payouts make up about 40 percent of the total income of people ages 65 and over. In addition, about two-thirds of those people receive at least half of their income from Social Security, and one-third receives at least 90 percent.[3] (In 2003, annual Social Security benefits averaged $10,740 per recipient.[4]) Trustees of the Social Security and the Medicare trust funds (the other government program of critical importance to senior Americans) predict that the programs will continue to run surpluses of more than $200 billion a year for at least the next decade.[5] However, based on current projections, Medicare will start running deficits in 2013 and run out of money in 2026, unless remedial action is initiated. Commencing in 2018, Social Security starts paying out more than it takes in and will begin dipping into its trust fund. Similarly, without remedial measures, by 2044, this trust fund also will be depleted.

Unfortunately, alongside the tenuous long-term financial viability of Social Security, there are serious problems associated with the other two legs of the symbolic retirement stool. In fact, it is becoming increasingly clear that relying on personal savings to bolster retirement income is not a realistic option for most Americans. According to the federal government, the nation's personal savings rate has plummeted from 11.2 percent of disposable income in 1982 (the highest level in the past three decades) to 1.7 percent in 2001, a precipitous decline indeed.[6] In its 2004 National Retirement Confidence Survey, Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), the giant financial service provider, reported that only 58 percent of workers in the survey indicated that they currently are saving for retirement at all, a proportion that has remained relatively unchanged since 2001.[7] Moreover, nearly half of all workers (45 percent), and a third of those 55 and older (29 percent), indicated that they have household assets, excluding the value of their home, below $25,000.

Further compounding this rapidly shrinking personal savings rate is the mountain of debt accumulated by most American households in recent years. In fact, even though consumer spending has been critical in propelling the economy forward in the aftermath of the 2001 recession, this has resulted in the accrual of substantial debt. Since 1999, household debt has leapt from 70 percent to nearly 83 percent of the current gross domestic product (GDP), i.e., the total value of goods and services produced in the nation.[8] Moreover, consumers racked up $1.1 trillion in new mortgage and consumer debt between the end of 2001 and the third quarter of 2003, increasing total consumer and mortgage loans held by Federal Deposit Insurance Corporation (FDIC) insured institutions to $2.6 trillion.[9]

Finally, the remaining leg of the figurative retirement stool, income flows from both public and private pension plans, is rickety too. Given the serious setbacks experienced by the stock market over the three-year period 2000 through 2002, both public and private retirement plans hemorrhaged enormous amounts of cash. After a monumental expansion in the five-year period 1995 through 1999, where the year-to-year change in the Dow Jones Industrial Average (DJIA) catapulted forward by almost 25 percent annually, in the 2000 through 2002 period, the year-to-year DJIA shrank by an annual rate of 10 percent.[10] The other major stock market indices, from the S & P 500 Index to the Russell 2000 Index to the Nasdaq Composite, all displayed identical trends for these two periods. In fact, the technology-heavy Nasdaq Composite was particularly affected by the severe declines on Wall Street during the same period.

These stock market developments and ongoing liability growth, according to the National Association of State Retirement Administrators, resulted in the actuarial funding levels of public retirement plans plunging to lower levels in fiscal year 2002 compared to fiscal year 2001.[11] Specifically, between the fiscal years 2001 and 2002, the actuarial value of public retirement systems' assets increased by 3 percent, or $57 billion; in contrast, liabilities grew by $154 billion or 8.1 percent. Also, the annual studies released in March 2003 and 2004 by the Santa Monica, California-based global advisory company Wilshire Associates confirmed this trend, indicating that the funding ratio (the ratio of pension assets-to-liabilities) for all state pension plans combined declined from 106 percent in 2001, to 91 percent in 2002, to 82 percent in 2003; the median (50th percentile) state pension plan had a funding ratio of 79 percent in the March 2004 survey.[12]

In a further setback to the nation's retirement systems, the Pension Benefit Guaranty Corporation (PBGC), the federal organization that protects the pensions of 44.3 million American workers, indicated in January 2004 that it was running a deficit of $11.2 billion and warned about its ability to protect private pensions in the future.[13] The PBGC, established as a federal corporation in 1974, and funded by insurance premiums set by Congress and paid by sponsors of defined benefit plans along with investment and other income, steps in to protect retirees in underfunded corporate pension plans. Given the woes experienced by corporate America recently, the agency's financial burdens have increased significantly. In 2003, the PBGC assumed responsibility for more than 152 underfunded retirement plans covering an additional 206,000 workers. Like the public retirement plans, underfunding among private pension plans was rampant and exceeded $350 billion in 2003, the largest figure ever recorded.[14]

There are many reservations associated with the different components of the nation's retirement infrastructure. Between the long-term viability of the Social Security trust fund, the low personal savings rate and high household debt levels, the uncertainties about the financial status of both public and private pension systems, it is prudent for policymakers and citizens alike to assess the situation and plot a suitable remedial strategy. When one factors in the sluggish nature of the current economic recovery, particularly the anemic levels of job creation between late 2001 and early 2004, the urgency for this remedial course becomes even more relevant.

In this context of the aforementioned brittleness in all three legs of the retirement stool, there has been a growing level of interest and scrutiny directed toward the portfolios of state and local government employee retirement systems by state policymakers. Some examples of this increasing scrutiny illustrate the growing importance of this topic. In Kansas, in February 2004, state leaders approved the issuance of $500 million in pension obligation bonds to shore up the public employees' pension system in an attempt to narrow the nearly $3 billion gap between future pension obligations and current assets.[15] In Maryland, investigations and pressure from legislators resulted in radical changes at the State Retirement System. These changes included the departure of senior executive staff, including the state treasurer (the titular head of the system), the indictment of a number of high-level officials on charges of defrauding the pension system and the introduction of outside consultants to improve internal policies and controls.[16] In New York, State Comptroller Alan G. Hevesi, the sole trustee of the New York State and Local Retirement Systems, indicated in January 2004 that he would block New York Governor Pataki's efforts to reduce the contributions state and local governments must make to the Systems.[17] (Governor Pataki was attempting to save $500 million by lowering the state's contributions to the Systems).

In July 2004, California Governor Schwarzenegger's proposal to borrow nearly $1 billion to cover payments owed public employee pension funds was termed to be "on shaky legal ground" by the state Legislature's chief attorney.[18] At the local level, the city of San Diego faces the prospect of a bankruptcy filing, largely because of a $1.2 billion shortfall in its pension fund for municipal workers; consequently, officials are scrambling to devise an adequate response to this looming financial disaster.[19] These examples are a sampling of the actions initiated by state policymakers across the country in their quest to enhance the financial position of these public retirement systems.

The focus of this report is to provide policymakers with another level of analysis to assist them in their deliberations as they devise methods to shore up the retirement systems in their states. In the last few years, these public retirement funds have been in the news, sometimes because of their shrinking asset base and sometimes for other reasons.[20] The importance of payments to beneficiaries from these state and local government retirement systems is a given and the onus is on policymakers to ensure the solvency and financial health of these plans. Notwithstanding the $2.2 trillion in cash and investment holdings in these retirement systems at the end of fiscal year 2002, more than 17.3 million total members and payments to over 6.2 million beneficiaries in 2002, there is considerable interest in ensuring that this component of the U.S. retirement system remains on firm financial ground and continues to flourish well into the future.[21]

State and local government employee pension plans and retirement systems cover the entire swath of public sector employees, from uniformed workers to teachers to members of the judiciary to legions of administrative and managerial positions. Even though there is a great deal of variety in their benefits packages, investment policy and administration, given their divergent histories and constituencies, these public sector plans are driven by similar core values and challenges. In essence, the administrators of all these plans seek to ensure the financial stability of the plans, in both the short and long terms, and to provide retirees with stipulated benefits by managing the plans' assets efficiently and effectively.

In order to provide an adequate backdrop to the analysis flowing from the U.S. Department of Commerce and The Council of State Governments' surveys, this report contains five chapters. Chapter 1 provides a brief history on the origins of public sector pension plans; highlights the differences between public and private pension plans; describes the different types of state and local government retirement systems; and enumerates basic information on the administration of these retirement plans. Chapter 2 expands on some of the themes mentioned in the introduction, such as the long-term viability of the Social Security trust fund; the abysmally low personal savings rate coupled with the high rate of debt accumulated by American households; and the financial woes associated with the federal Pension Benefits Guarantee Corporation, the government entity charged with rescuing underfunded private pensions. Chapter 3 documents the multiple economic challenges confronting states in the past few years, challenges that have negatively affected their public pension funds. Chapter 4 presents a wealth of statistical data and analysis flowing from the latest federal figures on public sector pension funds and, finally, Chapter 5 provides more details on the public sector retirement plans from around the country, including data contained in The Council of State Governments' survey.

Chapter 1
History and Origins of Public Sector Retirement Systems

The earliest public sector pension plan was established in New York City in 1857 to provide lump-sum benefits to policemen injured in the line of duty. This plan was amended in 1878 to offer the retirement payment of one-half of final pay to policemen completing 21 years of service. Even though a number of state and local entities followed New York City's example and began providing retirement payments to their former employees, it was not until the passage of the Social Security Act in 1935 that the growth of public sector pension plans burgeoned across the country. The impetus for this growth was the fact that the Social Security Act intentionally excluded state and local government employees from coverage. This was on the constitutional basis that the federal government did not have the right to tax state and local governments. Hence, a number of state and local jurisdictions pursued retirement plans as a means of covering their employees in the absence of Social Security payments to their retirees.

In tracing the growth of these plans, it is useful to divide their development into three distinct time frames.[1]

» **1930-1950**: More than half of the nation's largest public sector pension plans were established during this period, providing two-part retirement payments. The first part was paid by the employer based on the employee's salary and years of service at retirement, and the second part was based on annuitizing the employee's accumulated retirement contributions.

» **1950-1980**: In 1950, Congress amended the Social Security Act to allow states to voluntarily provide Social Security coverage for their employees after the state entered into an agreement with the Social Security Administration. Later on, Congress mandated Medicare coverage for state and local employees hired after March 31, 1986, another measure intended to boost the retirement incomes of public employees. Congress' decision to include states under the Social Security Act initiated a number of changes in state and local government plan designs. For instance, for a number of years, many of the state and local plans joining Social Security offered a split-benefit formula, with a lower unit benefit percentage applying to the first $4,200 of final average salary and a higher unit percentage applying to the amount over $4,200. ($4,200 represented the Social Security covered earnings ceiling at the time.) However, in the 1980s, many of these plans dropped this split-benefit approach and returned to a single-benefit approach. The 1960s and 1970s witnessed a growing consolidation among plans with the larger plans enveloping the smaller ones to take advantage of economies of scale and improved technologies.

» **1980 to the present**: A major development during this period involved the increasingly significant role played by state legislatures in expanding the investment options for public sector pension plans. Beginning in the early 1980s, state legislatures cleared the way for pension plans to adopt "the general standard of prudence" to guide investment decisions in contrast to the severely restrictive "legal list" approach. In the former era, public pension plans only could invest in certain types of securities, investigated and approved by the state legislature. For instance, many legal lists limited the maximum percent of assets held in common stock to 30 percent or less. Table 1 provides a quick review of the government vs. non-government securities split held in the portfolios of state and local government employee retirement systems in 1993 and 2002, as enumerated in the federal data.

Government vs. Non-government Securities Split in Public Retirement System Portfolios 1993 vs. 2002				
	FY 1993		FY 2002	
Type of Security	Dollar Value	% of Total	Dollar Value	% of Total
Government	$203,452,928	22%	$225,584,917	10%
Non-government	$571,391,516	62%	$1,649,810,584	76%
* Corporate Bonds	$174,446,987	19%	$352,193,553	16%
* Corporate Stocks	$301,315,623	33%	$814,835,143	38%
* Mortgages	$19,458,912	2%	$20,765,586	1%
* Funds Held in Trust	$28,682,820	3%	$70,422,530	3%
* Foreign Securities	0	0	$254,662,228	12%
* Other	$47,487,174	5%	$136,931,544	6%

table 1

Source: U.S. Department of Commerce, Bureau of Economic Analysis, 1993 and 2002

As indicated in Table 1, after the relaxing of stipulations regarding these public retirement systems pursuing investments in non-governmental instruments there was a marked difference in the government vs. non-government securities composition. After reaching a 22 percent and 62 percent split in 1993, the composition shifted to 10 percent and 76 percent in 2002. Under the new prudence standard, the pension plans were free to invest a larger share of their assets in equities, most often domestic, a trend that enabled a vast majority of the pension plans to take full advantage of the tremendous surge in the stock market demonstrated in the mid- to late-1990s. While the movement to the prudence standard contributed to solid financial gains during this period, the steep market drop-off in the first three years of this decade also resulted in a shift to a more conservative investment strategy.

Public and Private Sector Pension Plans: Major Differences

The extension of the retirement period at the conclusion of the average American's working life remains one of the more striking features of the past century or so. While this development speaks volumes for the tremendous and much sought-after advancements in medical technology, it does pose a fresh set of challenges for public policymakers at all levels. In response to this trend, the United States developed a number of government and private sector pension plans, or long-term financial contracts, that promise to pay retiring workers a sum of money to meet their expenses during retirement.

An overview of state and local government retirement plans requires a description *vis-a-vis* their private sector counterparts. Public sector plans across the United States tend to be of the Defined Benefit (DB) variety, i.e., retiring vested employees receive a specified retirement benefit, based on age, years of service and salary, throughout the duration of their retirement. In fact, defined benefit plans are the primary retirement benefit for 90 percent of the full-time employees of state and local governments.[2] It should be noted that until recently, private corporations also offered these defined benefit plans to their retirees. These traditional pension plans are becoming extremely rare in the private sector and in the past five years, no firm has launched an old-style pension plan; in fact, a number of companies have terminated them.[3]

In these public sector DB plans, required contributions are computed by actuarial evaluations while the plan's investments are managed by financial experts selected by the public sector entity's pension board or board of trustees. DB plans are not "pay-go" plans, i.e., where inflows match outflows, but plans where the liabilities are amortized over a specified period, similar to a mortgage.

On the other hand, in the private sector, a large number of employees are covered by Defined Contribution (DC) plans, in which the amount contributed to the plan is specified even though the benefit payout is not. Under this system, private sector plan participants maintain a great deal of leeway on where to direct their investments, within certain investment parameters, or options, pre-selected by the employer. Benefit payouts to private sector retirees flow from the contributions and investment income that accrue in participants' accounts. In the event that funds in these accounts are insufficient to pay benefits for the duration of retirement, private sector retirees have to rely on alternate income sources.

About 57 percent of full-time workers in the private sector are covered by some sort of company retirement plan, a proportion that has not changed substantially in recent decades. What has changed is the type of coverage provided by companies: in

1980, 60 percent of plans were traditional, DB plans. By 2000, that proportion had slumped to 13 percent as more and more companies resorted to 401(K) and DC plans.[4] In terms of the public sector, some 43 percent of public workers are unionized and as noted earlier, 90 percent are participants in fixed-benefit, DB plans. Meanwhile, in the private sector, where only about 9 percent are unionized (less than half the percentage of 20 years ago), the availability of DB plans has been shrinking as noted above. In addition, public employees typically collect higher benefits as a percentage of final pay than do those in private-sector fixed-benefit plans.[5]

Cash balance plans and other so-called hybrid plans are geared toward capturing the advantages of both DB and DC plans and have emerged as a strategy for firms to offer pensions often at a lower cost.[6] These cash balance plans work in the following manner: while the company regularly allocates money aside for employee retirement, unlike the popular 401-K retirement plans, the company, not the employee decides how that money is invested. In essence, these cash balance plans, legally classified as DB plans because the employer owns the assets, makes the investment choices, bears the direct investment risk and maintains adequate reserves, as required by law. At retirement, employees have accumulated a nest egg to draw down during retirement without the responsibilities of managing a portfolio of stocks and bonds. Yet, the employee's accrual of pension rights resembles that of DC plans; hence, the terming of these cash balance plans as hybrid. A number of private firms have switched to these cash balance plans in recent years to economize on their payments to retirees, including Aetna, Inc. (in 1999), American Express (1995), AT&T Corporation (1998), Avon Products (1998), Citigroup, Inc. (1996), Goodyear Tire & Rubber (1998), IBM (1999) and Owens Corning (1996).

While the employer contributes to the employee's retirement account, typically as a percentage of current earnings, workers who switch jobs prior to retirement may withdraw or transfer the account balance to other tax-sheltered accounts. The employer also provides a credit based on the account balance at an interest rate specified in advance, rather than depending on the performance of financial markets (like DC plans). The interest credit rate may change over time at the discretion of the employer.

As indicated, DC and DB plans differ in several ways and both the private and public sector retirement plans in contemporary American society sometimes incorporate various aspects of these DC and DB plans. Table 2 provides a comparison of some of these differences.

There also are major differences in public sector and private sector plans in the actual implementation or logistical stages. For instance, most public sector employees tend to be included in their pension plans at the point of employment, while private sector employees generally must meet an age and/or length of service requirement in order to be eligible for coverage. It should also be noted that being legally eligible to receive retirement benefits only occurs after an employee, either private or public, is vested in the retirement system. In general, public sector employees take longer to vest in their retirement systems (43 percent of public employees have to

Characteristics of Employer Pension Plans

	Traditional Defined Benefit (DB) Plans	Defined Contribution (DC)/ 401(k) Plans	Cash Balance Plans
Funding	Employer	Employee and Employer	Employer
Financial Market Risk Borne By	Employer	Employee	Employer
Benefits Determined By	Years of Service and Final or Highest Average Pay	Contributions (based on current wages) and Investment Returns on those Contributions	Pay Credits (based on current wages and interest credits)
How Benefits Are Typically Paid at Retirement	Annuity	Lump Sum	Annuity or Lump Sum
Access to Funds for Current Workers Prior to Retirement	No	Yes (through loans and hardship withdrawals)	No
Guaranteed by PBGC	Yes	No	Yes

table 2

Source: Gale and Orszag, April 2003[7]

work 10 years before becoming legally entitled to a benefit) while private sector employees typically vest after five to seven years of employment.

The federal Employee Retirement Income Security Act of 1974 (ERISA) requires private pension plans to provide plan members and the U.S. Department of Labor with periodic reports about plan performance and new developments. Even though the state and local government plans are not bound by these ERISA requirements, the plans' administrative entities seek to comply with the financial measurement and reporting mechanisms specified by the Governmental Accounting and Standards Board (GASB). As a result, public sector plan participants and other interested parties and regulatory agencies can review the performance of these public sector plans against the relevant GASB standards.

It also is important to note that about one-fourth of state and local government employees do not participate in Social Security, opting to channel their Social Security payroll deductions to their state or local government retirement plans.[8] This trend raises the importance of the adequacy of their income flows from the state or local government retirement plan during retirement given that they will not receive a monthly check from the Social Security Administration. In fact, 40 percent of teachers in state and local government plans, including all or mostly all in California, Connecticut, the District of Columbia, Florida, Illinois, Kentucky, Maine, Missouri and Texas do not make Social Security contributions. Similarly, some 75 percent of public safety workers and most public employees in Alaska, Colorado, Louisiana, Massachusetts, Nevada and Ohio do not make Social Security contributions either.

Even though state and local government plans tend to be of the DB model, there are several public sector plans that have adopted the DC model. For instance, the State Employees Retirement System of Nebraska, the Teachers' Defined Contribution Plan of West Virginia, and Michigan's State Employee Plan (for workers hired after 1997) have opted for the DC variety. There also has been interest in adopting plans that have taken on characteristics of both the DB and DC plans. In sum, these efforts are a direct consequence of the changing economic and political environment in the country and reflect the desire of plan administrators to cultivate the most financially viable scenario for their participants.

Types of Public Sector Retirement Systems

A review of the different public sector retirement systems quickly reveals the tremendous variations among the numerous plans, including the level of benefits provided, type of employees covered, structure of the entity administering the plan, number of contributing employees, size of the plan's portfolio and investment philosophy driving the plan. In addition, these variations contribute toward distinguishing the public sector plans from those adopted by the private sector. The following section highlights some of the features of the retirement plans of major public sector professions.

One of the more common variations among public sector plans is that they cover employees with radically different employment characteristics. For instance, the physically demanding and very often dangerous nature of law enforcement and fire fighting enables these employees to retire at an earlier age in comparison to other public sector employees. (These professions also seek a workforce with an average age that is younger than other public sector professions; hence, the higher number of retirees at an earlier age.) Consequently, the retirement benefits extended are very different from other public service positions. Typically, retirement benefit formulas for these professions are linked to the specific plan's vesting requirements. Most plans that require 20 years of service for vesting purposes operate on benefit formulas that specify a flat percent of final average salary, most often 50 percent, to be paid upon retirement. Plans that allow vesting after five or 10 years calculate benefits based on formulas derived from single-rate or variable-rate multipliers for each year of service. As opposed to the single-rate approach by which the benefit percentage remains unchanged. In the variable-rate approach, a participant may accumulate a retirement benefit of a certain percentage for the first five years of service and another percentage for the remaining years of service.

In comparison, the retirement benefit formula for teachers' retirement plans usually involves a single-rate benefit calculation with the same benefit multiplier applying to all years of service under the plan. Many teachers' pension plans offer an early retirement option by which employees can retire, with unreduced benefits, before reaching the specified age and service requirements. Most often, this option is available after the employee puts in 20 years of service. A large number of the teacher pension plans add an automatic cost-of-living adjustment to their benefit payouts to ward off the negative effects of inflation.

With regard to the general employee retirement plans, age and service requirements are very similar to those extended to participants in the teachers' plans. Similar to the teachers' plans, single-rate benefit calculations are used with many systems offering unreduced retirement benefits at age 55, with 25 or 30 years of service. Like the teachers' plans, retirement payouts are computed using the final average salary, typically based on the highest three or five years of service.

Several interesting developments are apparent in recent times including the movement away from the integration of benefits with Social Security, a trend that is reflected in both the public and private sector plans. As a result, the U.S. Bureau of Labor Statistics notes that the proportion of public plans with a benefit formula linked with Social Security benefits declined from 10 percent to 4 percent between 1992 and 1994; for private plans, the proportion declined from 63 percent to 51 percent between 1989 and 1995. A plausible explanation for this trend may be the perceived uncertainty regarding the solvency of the Social Security Trust Fund. As noted earlier, one-fourth of state and local government employees do not participate in Social Security, opting to channel their Social Security payroll deductions to their state or local government retirement plans.

Another important development involves the evolution of Deferred Retirement Option Plans (DROPs), a development traceable to certain demographic and economic pressures. This type of pension benefit, spurned by corporations but often embraced by state and local governments, has been hailed as a mechanism to retain hard-to-replace teachers, engineers and other public workers on the job as they near retirement.[9] In essence, employees eligible to retire are allowed to continue working while their retirement benefits are placed in a fund until they retire for "real." However, since DROPs allow for a very early retirement at high levels of final wage replacement, high guaranteed rates of return and lucrative cost-of-living adjustments, the negative implications on the finances of these government entities during a fiscal downturn remain significant. During the booming 1990s, when equity markets roared forward, these negative developments did not surface but in the current era, when state finances and public retirement systems remain under tremendous pressure, these DROP plans are proving to be immensely costly.

The genesis of DROPs may be traced to a handful of police officers and firefighters in Baton Rouge, Louisiana, coming up with the idea (in 1982) of tapping their pension funds to create individual escrow accounts before they retired. Their pension plans, like most traditional ones, paid their benefits in a flow of checks every month, i.e., an annuity. These officers, working with an actuary, devised a system where if they turned down the longevity raises they were entitled to just prior to retirement, their pension fund could deploy that money to establish individual accounts. In the current context, when an employee becomes eligible to retire, the individual opens an escrow account and keeps on working at normal pay. While the employee's pension benefit stops growing—as if the employee had retired—the pension fund forwards monthly annuity checks to the previously mentioned escrow account. Not only does this escrow account accumulate interest, certain government entities guarantee a specified rate of return on these funds. When the employee finally retires, the employee is handed a lump sum, i.e., the proceeds of the escrow account, and then the employee gets the monthly pension check, which are based on the benefit level before the escrow account was created. Very soon, the concept of DROPs (numerous variations on the DROP, such as the DRIP, the PLOP, the BACK-DROP also surfaced in ensuing years) caught on more and more with firefighters, police officers and spread to teachers, judges and many other categories of public employees. While pension fund officials assumed that the costs of the "sweeteners" that were added onto these plans could be paid for by the ever-surging stock market, the downturn in the market between 2000 and 2002 resulted in these public pension plans having to absorb enormous costs.

One government entity facing these negative pressures--the city of Houston-- introduced a very attractive early retirement plan for city employees back in the early 1990s. Employees were permitted to retire at 45 years of age (after completing 25 years of service) with a guarantee of 90 percent of their final salary. Consequently, 44 percent of the city's workforce opted for retirement in a five-year period, forcing the introduction of a DROP plan to retain some of these employees. The carrot offered to employees who enrolled in the DROP plan was a guaranteed 8.5 percent rate of return on their retirement funds that were not drawn, a rate of return that seemed reasonable at that time but exorbitant in the current environment of wilting equity markets and interest rates. In fact, while hundreds of older workers will qualify for million-dollar payouts from these accounts, when their monthly pension checks start arriving, some actually will have higher incomes than they did when they were working. As an example, the director of human resources for the city of Houston (who has 30 years service) will receive a $1.5 million check from the city's DROP and then, when he turns 60 in seven years, will receive monthly pension checks totaling about $110,000 a year.

To further complicate matters in Houston, the city's pension fund faced a $1.9 billion shortfall along with the huge financial burden of the DROP plans. In response, Houston's voters exercised their rights to opt out of this guaranteed public employee pension benefit in a referendum--authorized by the Texas constitution--that allows cities a single opportunity to withdraw from such guarantees. In fact, the financial burdens associated with the pension fund shortfalls and the extremely high payouts associated with the DROP plans resulted in the rejection of the pension guarantee provision in the May 2004 referendum.

Alongside Houston, the cities of Philadelphia, San Diego and Milwaukee also face serious financial difficulties in meeting the overall pension obligations as a result of these DROPs. In San Diego, the generous DROP plan may have contributed to a $1.2 billion shortfall in the city's pension system, a shortfall that triggered downgrades in the city's bond rating and a federal investigation.[10]

Even at the state level, certain states sought to refine their retirement benefits. During its 2004 legislative session, lawmakers in South Carolina considered trimming a program the General Assembly had created in 2000. The Teacher and Employee Retirement Incentive (TERI) program in South Carolina allowed employees to continue working for five years after retiring with their monthly pension checks being assigned to a special account; as in the DROPs, employees could access the funds in these accounts when they finally retire. House Bill 4888 in South Carolina sought to remove the earning limitation for a retiree and then eventually phase out the entire program. Yet, there was a great deal of opposition to this proposal and the bill's author requested that the bill be removed from the legislative agenda for the year.

Administering Retirement Systems in the Public Sector

Policymakers continue to play an important role in the administration of public sector retirement plans for the obvious reason that these funds involve substantial amounts of public money. In recent years, the enormous growth of these plans, both in terms of asset size and participants, has increased the level of scrutiny as well. In general, state and local retirement systems are managed by a retirement board or board of trustees that maintain responsibility for investment policy and asset allocation. These board members act as fiduciaries and are required to use their best judgment and prudence in investment decisions so that the financial viability of these plans is secured. A survey conducted by the Florida Retirement System several years ago indicated that 93 percent of the retirement systems or funds across the country are governed by such a board. In addition, 67 percent of these boards retain authority over investment decisions, 62 percent have authority over benefits and 85 percent have authority over actuarial assumptions.[11]

According to the U.S. Department of Commerce, in 2002, there were 2,670 public employee retirement systems or plans in the United States. Nationally, Pennsylvania (931), Illinois (371) and Florida (158) were the top three states in terms of number of plans. Two additional states—Michigan (142) and Minnesota (146)—also ranked high in this connection. It appears that in some states, local and state government employees are consolidated in a few plans while in other states, there are a large number of plans also serving local government entities.

As noted earlier, even though public sector plans are not subject to the standards of the federal ERISA law, a vast majority of these plans include language extracted from this federal law in their guidelines. For instance, public retirement funds are required to be invested using the "prudent person rule." Specifically, the prudent person rule states that "fiduciaries discharge their investment duties with the same degree of diligence, care and skill which a prudent person would ordinarily exercise under similar circumstances in a like position."[12] The daily administration of these plans often is the responsibility of the retirement system's staff, or of the government controlling the system, operating under the supervision of an executive director who, in turn, reports to the board of trustees.