

# Solving the Public Pension Plan Dilemma

BY DAN VAN BOGAERT

*This article examines the current status of state and local government retirement systems relative to the private sector and analyzes different points of view on the broad and complex issue of the reform of public employee pension plans.*

The following is an objective analysis of the more prevalent arguments for and against reform of public employee pension benefits at the state and local levels. The focus is on three key areas: (1) funding, (2) benefit levels, and (3) collective bargaining rights, and the conclusion lists practical recommendations for each.

## Background

It is useful to begin the analysis with a review of the current status of state and local government retirement systems.

State and local governments continue to provide essential public services, e.g., public safety, education, public systems (infrastructure), regulation, and fiscal management. Their retirement plans fall within two general categories, *Defined Benefit* ("DB") plans and *Defined Contribution* ("DC") plans [access <http://www.dol.gov/dol/topic/retirement/typesofplans.htm> (Retrieved March 26, 2011)]. DB plans are the predominant type of retirement plan in the public sector.

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They must be consistently well-managed to attract and retain qualified talent needed to deliver unique public services, to ensure benefits will be available when employees retire, and to ensure efficiency and value for taxpayers.

## Historical Perspective

The first public pensions in the U.S. were informal promises made to volunteers in the Revolutionary War (1754–1783) and Civil War (1861–1865), which evolved into formal DB plans offered to federal government employees under the Civil Service Retirement System (1920). State and local governments gradually started to sponsor their own similar DB plans [e.g., <http://www.usgennet.org/usa/topic/colonial/census/1840/1840a.html> and <http://www.genealogymagazine.com/patriots.html>; 1840 Census of Pensioners Revolutionary or Military Services. (Retrieved September 6, 2011)].

Today, one-fifth of private industry workers, and nearly four-fifths (79 percent) of state and local government workers, participate in DB plans [[http://www.aon.com/attachments/dbdc\\_serp\\_aug2010.pdf](http://www.aon.com/attachments/dbdc_serp_aug2010.pdf); U.S. Bureau of Labor Statistics, *Program Perspectives*, 2(3), April 2010; <http://www.ncsl.org/?tabid=18511> (Retrieved March 26, 2011)]. Most states have at least one retirement system, primarily as a product of collective bargaining covering millions of state and local government employees. There are more than 87,000 local government entities with approximately 11 million employees, or roughly two-thirds of all government employees. [See, e.g., U.S. Government Accountability Office, GAO 08-317, "State and Local Governments: Growing Fiscal Challenges Will Emerge During The Next 10 Years" (2008) (Retrieved March 26, 2011).] According to the 2011 U.S. Census, the number of government employees is broken down as follows: federal 2,527,149; state 3,836,544; local 11,114,889. In 2010, there were almost 17 million government workers who participated in DB pension plans.

Until the advent of 401(k) plans (which are a type of DC plans) in the 1980s, DB plans were the dominant vehicle through which private and public sector employers in the U.S. provided pension plan benefits to employees.

## Reform of Public Pension Plans: Arguments For and Against

### Funding

Public retirement systems are not the cause of our bad economy. Nevertheless, it is essential for

the financial integrity of public pension plans that there is enough money to pay for promised benefits. Strengthening funding practices is appropriate for public sector DB plans to minimize risks of cost increases unintentionally being passed along to taxpayers to make up for funding shortfalls.

#### Arguments in Favor of Reform of Government Pension Funding Practices

Significant declines in the value of plan assets—both in absolute terms and relative to liabilities—have heightened concern over the funding of DB plans. Concern, however, is justified not just during downturns in the equity market, but at any time when there is an increased risk that plan assets may be insufficient to pay benefits.

Consequently, some argue that the funding ratio—that is, the actuarial value of DB plan assets divided by the actuarial value of its liabilities—should be maintained at or near 100 percent to insure that plan assets are sufficient to meet benefit payment obligations. Public sector DB plans should conform to this higher standard.

Underfunding becomes a serious problem when it results in an increase in taxes that have to be paid by taxpayers who are not participants in the public DB plan, or in reduced services to taxpayers. The primary causes of underfunding are the absence of uniform minimum funding standards, a general lack of regulations, and/or overly generous benefit levels. These causes do not necessarily lead to automatic abuses, but there certainly have been coincidental instances of abuse. For example, in the city of Bell, California, a 17-year tenured Chief Administrative Officer, one of eight city officials arrested for various alleged crimes, paid himself a final annual salary of \$787,000 [<http://www.wavenewspapers.com/news/State-audit-says-Bell-lacked-internal-controls-on-city-finances-103540279.html>].

Public DB plans may be more susceptible to incurring risky low funding ratios due to the general lack of uniform standards. In 2007 and 2008, more than 60 percent of the largest state and local pension plans were at least 80 percent funded, but the funding ratio for all state DB plans was averaged only about 65 percent in 2009 [2009 Wilshire Consulting study; Wilshire Associates Incorporated, 1299 Ocean Avenue, Suite 700, Santa Monica, CA 90401; [consulting@wilshire.com](mailto:consulting@wilshire.com) (Retrieved March 26, 2011)]. New Jersey public DB plans were underfunded by \$54 billion in 2010 [[http://www.nj.com/news/index.ssf/2011/03/nj\\_waiting\\_for\\_irs\\_approval\\_of.html](http://www.nj.com/news/index.ssf/2011/03/nj_waiting_for_irs_approval_of.html) (Retrieved March 24, 2010)].

Reform is needed because of wide differences in the funding ratios each year among individual state and local DB plans. Generally, they range from 80 percent or higher (subject to exceptions). What is an acceptable funding ratio depends upon several factors, such as size and maturity of the plan, complexity of benefit formulae, participant demographics, anticipated rate of investment return on plan assets, and consistency of contributions. A common criticism of public DB plans, however, is that they tend to use overly optimistic assumed interest rates without phasing in "smoothed asset values" during years in which there are strong equity returns. For example, public DB plans typically used assumed interest rates between eight and eight-and-a-half percent during 2009–2010, while private sector DB plans assumed interest rates averaged less than six percent. [See, e.g., Proctor & Gamble (5.6%), Kellogg's (4.8%), Johnson & Johnson (5.98%), PNC Financial (5.2%), following 2008, in which there were major equity losses.] Inadequate funding also occurs when irregular actuarial practices are incorporated into the annual plan valuation process, such as when benefits are added without providing for sufficient funds to cover new liabilities.

Private sector employers may go out of business when unrealistic and overly generous assumed rates of return on investment of plan assets are regularly used. However, it is extremely rare that government employers to go out of business when doing the same thing. They may fall back on the support of the general public to rescue them from such mistakes.

#### Arguments Against Reform of Government Pension Funding Practices

Public DB plans have a history of using nonuniform actuarial approaches for funding and reporting purposes. Therefore, some argue that it is difficult to make comprehensive comparisons between public and private sector DB plans to prove the need for funding reform. Furthermore, many state and local DB plans are already adequately funded.

Additionally, the Government Accounting Standards Board (GASB) recently provided adequate general guidelines for public DB plans for accounting and financial reporting. These guidelines, some argue, are all that is needed to correct the funding levels of underfunded plans, and that the funding status of public DB plans in general is no better or worse than private sector DB plans. Even those DB plans with

low funding ratios are not seriously at risk because the investment losses may be made up as the economy strengthens.

### Benefit Levels

The big picture needs to be examined to reach a logical conclusion as to whether the level of retirement benefits needs reform. Therefore, the following factors need to be analyzed first:

- The earliest age at which benefit payments may start;
- The percentage of pre-retirement income replacement ("replacement ratio");
- The formula used to determine the monthly benefit; and
- The existence of any supplemental retirement plans and retiree health insurance.

Once these factors are analyzed, they may be objectively compared to equivalent benefit levels of private sector DB plans.

One of the challenges of making objective comparisons is the fact that employers typically have other retirement plans to supplement their DB plans, each with different benefit formulae. (There are essentially three types of formulae under DB plans used to determine the amount of monthly benefit: (1) final or best average earnings; (2) career average earnings formula; and, (3) flat benefit formula.) Also, what counts as "pensionable earnings" or years of service for purposes of these formulae varies, which affects benefit levels.

### Arguments in Favor of Reform of Government Pension Benefit Levels

Many government jobs are unique and not comparable to any private sector positions. Nevertheless, the public's perception that government employees in positions that are comparable to private sector benchmark jobs are paid more is confirmed by several studies. [See, e.g., U.S. Bureau of Labor Statistics, [http://www.usatoday.com/news/nation/2010-03-04-federal-pay\\_N.htm](http://www.usatoday.com/news/nation/2010-03-04-federal-pay_N.htm); Bureau of Labor Statistics (average federal salary exceeds the average private sector pay in 83 percent of comparable occupations); and [http://www.usatoday.com/news/nation/2010-03-04-federal-pay\\_N.htm#chart](http://www.usatoday.com/news/nation/2010-03-04-federal-pay_N.htm#chart) (Retrieved March 20, 2011).] It is, therefore, logical to conclude that the amount of benefits earned under public DB plans would also be greater on average than under private sector DB plans. [See, e.g., <http://www.bls.gov/news.release/union2>.

<http://www.fixpensionsfirst.com/>] Public DB plans are typically based on final or best average earnings formulae, which produce the most generous benefit levels, particularly when practices are used to expand the definition of "pensionable earnings."

The related trend of state and local governments switching from DB plans to DC plans may in itself be an indication that DB plan benefits are too generous and expensive. Of the 11 states that have public DC plans, three offer a DC plan exclusively as the only retirement plan. The other eight states offer a DC plan as an option.

### Arguments Against Reform of Government Pension Benefit Levels

It is difficult to prove that the "average" public DB plan benefits are too expensive and more generous than private sector DB plans. Despite the wide variety of DB Plans and combinations of DB and DC plans that exist, there are some characteristics of public DB plans that distinguish them from private industry DB plans. The vast majority of state and local government employees are members of unions, and the DB plan features are the result of the collective bargaining process. Some studies claim that state and local government employees are not overpaid. Note, however, that none of these studies seem to have been conducted by independent third parties with private sector experience in compensation management [<http://www.ile.berkeley.edu/cwed/wp/2010-03.pdf>, "Public Employees in California: They Are Neither Overpaid nor Overcompensated," *Policy Brief*, October 2010, by Allegretto and Keefe]. The conclusion of the Allegretto and Keefe study states:

Taxpayers exert considerable pressure on elected representatives to resist increases in compensation, which creates a formidable incentive and opportunity to hold government pay below market rates. [Id., page 13.]

This study also omits the fact that California and New Jersey are not right-to-work states, that is, employees do not have the right to decide for themselves whether to join or financially support a union. In fact, union workers have greater influence over elected representatives to grant wage and benefit increases, based on union dues collected by officials who contribute to the election campaigns of those who approve such increases.

Some also argue that the debate over reform of public DB plan benefit levels is irrelevant because pay and benefits are the general subject of legitimate collective bargaining. This argument holds that a "fundamental right" of workers is involved, and these bargaining items may not be interfered with. Any reform "give-back" relating to benefit levels would have to be negotiated and union contracts formally amended.

Another argument against reform points to disadvantages of switching to DC plans. Switching to public DC plans to effectively reduce costs of retirement may not necessarily be beneficial for public employees. Under DB plans, the employer/plan sponsors—government entities—assume the risk associated with investment of plan assets. DB plans, therefore, guarantee that the employee will receive a certain benefit level upon retirement. DC plans, on the other hand, provide whatever benefit the contributions and investment returns afford, which could be better or worse than the DB plan would provide, and may be much more dependent on the number of years during which the employee participates and earns contributions and asset growth.

The majority of state and local DB plans also provide disability and survivor benefits, as well as retirement income. "Switching to a DC plan would require employers to obtain these benefits from another source, likely at a higher cost" [National Conference on Public Employee Retirement Systems; [http://www.ncpers.org/Files/2011\\_ncpers\\_research\\_series\\_top\\_ten.pdf](http://www.ncpers.org/Files/2011_ncpers_research_series_top_ten.pdf); see also *Defined Contribution Savings Plans in the Public Sector: Lessons from Behavioral Economics*, Beshears, Choi, et al.; <http://www.economics.harvard.edu/faculty/laibson/files/Public%2BSector%2BDC%2BPlans%2B2010-09-16%2Bcomplete.pdf>, prepared for the NBER State and Local Pensions Conference, August 19-20, 2010; National Association of Government Defined Contribution Administrators].

### Collective Bargaining Rights

Collective bargaining rights are undoubtedly the most controversial of the key reform issues. Not surprisingly, calls for limiting collective bargaining rights have been met by strong objections from government unions.

#### Arguments in Favor of Reform of Collective Bargaining Right

Because of built-in conflicts of interest within the current collective bargaining process, reform seems justified. For example, mandatory dues deducted from

paychecks of employees are in large part transferred to political candidates and incumbent politicians, who are frequently influenced to return the favor by later approving—directly or indirectly—wage and benefit increases. [See <http://www.gao.gov/new.items/d10754.pdf> (Retrieved March 17, 2011).] Such conflicts unduly complicate plan administration, and hinder the ability to efficiently implement appropriate plan design and operational changes.

Also, those who are in favor of limiting collective bargaining rights of public employees commonly believe that there is a conflict between the union workers and the civil rights of the majority of nonunion workers who help pay for public DB plan benefits.

#### Arguments Against Reform of Collective Bargaining Rights

The counterargument to those who propose to limit—or even eliminate—collective bargaining rights is that such actions would just be the first step to take employees back to pre-union work standards. Public sector union membership has expressed a concern over being used as scapegoats because of budget deficits. [See, e.g., [Don'tscapegoatus.com](http://Don'tscapegoatus.com) (Retrieved August 1, 2011).] The concern is that workers would no longer have a fair say in anything to do with their work.

Legislation for initial collective bargaining grew out of studies authorized by the National Governors' Conference in 1962. Those states that do not have any such legislation have permitted voluntary bargaining based on court decisions structured on constitutional rights of free speech and assembly. In other states, there are statutory limits on collective bargaining involving *impermissible subjects*, as opposed to mandatory subjects.

After many years of accepting the public sector's legal right to collective bargain, it cannot be arbitrarily be taken away unilaterally by the government entity. For example, state employees in Wisconsin have had collective bargaining privileges for 50 years. The argument put forth is that the right to collective bargaining is effectively a quid pro quo for government workers accepting a prohibition on the right to strike.

Others believe that restriction of collective bargaining rights of public sector unions is not favored by the general public (although other polls show just the opposite). [See, e.g., February 22, 2011, USA TODAY/Gallup Poll; Contra: A Rasmussen poll, February 23, shows that voters are supportive of Governor Scott

Walker in the Wisconsin dispute.] The League of Cities and Municipalities in several states have also published opinions that collective bargaining enables them to make government more efficient.

### Reform Recommendations

Based on an objective analysis of the for and against arguments, participants, state and local governments, and taxpayers in general would benefit from efforts to implement the following practical key recommendations regarding changes to funding, benefit levels, and collective bargaining. [E.g., Public Pensions for Retirement Security, by Commission on California State Government Organization and Economy, known as the Little Hoover Commission; <http://www.lhc.ca.gov/studies/204/Report204.pdf>.]

Originally, private industry retirement savings plans had no minimum standards to protect participants and their savings. There was just a patchwork of uneven laws from state to state, with a general lack of uniform minimum standards—until the enactment of the comprehensive Employee Retirement Income Security Act (ERISA) in 1974. Public DB plans are not subject to ERISA. More than three decades later, public DB plans still lack uniform minimum standards and basic protections similar to the pre-ERISA private sector.

### Funding

If GASB guidelines, e.g., Statements 5, 25, and 27, are to be relied upon by public DB plans, then they should be amended to strengthen certain funding standards, as follows:

- Plans should adhere to a minimum funding ratio of no less than 80 percent to ensure that enough contributions and investment return are set aside to meet promises. Under the Pension Protection Act (“PPA”), only private industry pension plans must pursue a 100 percent funding ratio [PL 109-280; <http://www.dol.gov/ebsa/pensionreform.html>]. Interestingly, the Pension Benefit Guaranty Corporation, which guarantees certain private sector DB plan benefits and currently provides partial benefits for 3,800 terminated pension plans, has a funding ratio of approximately 80 percent.
- When there are greater than expected returns on investment, the impulse to grant benefit increases to employees with these “extra” funds should be resisted. Lower than expected returns may follow in subsequent plan years, resulting in underfunding. It is better to ensure proper funding of the benefits in existence than to incur additional liabilities that may be more than the entity can afford in the short term.
- The use of overly optimistic assumed rates of investment return in actuarial valuations should be replaced with a policy that emphasizes disciplined conservative rates, similar to those used by actuaries in private industry. States’ sovereignty precludes the federal government from directing that government DB plans, such as requiring lower discount rates. The objective is to avoid significant underfunding. Investment policies for DB plans should prohibit a strategy of waiting passively for better investment returns to recover from low funding ratios. Public pension plans typically assume eight percent annual return on average, but during 2006–2010 state pension plan assets earned on average only 4.5 percent [National Association of State Retirement Administrators 2010; [g.donlan@barrons.com](mailto:g.donlan@barrons.com)].
- Persons who have discretionary authority and responsibility under the plan, including decisions that impact funding, should be held accountable as fiduciaries, similar to federal standards required under ERISA GASB guidelines should include a clear definition of fiduciary, similar—but not identical—to the federal law, ERISA Section 3(21)(A)(i), including those who (1) exercise discretionary authority or responsibility in the administration of the employee benefit plan; (2) exercise authority or control respecting management or disposition of plan assets; or (3) render investment advice with respect to plan assets (or has any authority or responsibility to do so) for a fee or other compensation, other than regular compensation received as an employee of the plan sponsor. A public retirement plan fiduciary would, however, have limited immunity from personal liability under applicable statutes. [E.g., 42 U.S.C. § 1983; More detailed information is available at <http://www.davidvogel.com/articles/StateImmunities.pdf>, and [www.seethebenefits.com](http://www.seethebenefits.com) (Retrieved May 18, 2011)].
- Funding practices should encourage contribution patterns that reflect a disciplined counter-cyclical policy of building reserves against market downturns. For example, employee contribution “holidays” should be prohibited. Instead of suspending contributions during periods of greater than expected returns, maximum level of fund surplus should be raised.

- Disclosure of annual financial and actuarial reports should be required, similar to requirements under PPA for private sector DB plans. Besides traditional information reported by independent plan actuaries, required information should also include:
  1. The minimum required contribution;
  2. Funding ratio (total plan assets divided by total plan liabilities);
  3. "Sensitivity analysis" of risks showing the likely consequences of a worst case scenario regarding assumptions used in the valuation;
  4. Transactions involving conflicts of interest;
  5. Dollar amount and percentage of current and amortized liabilities supported by taxpayers in relations to total liabilities; and
  6. Other data that may be deemed appropriate.
- Disclosure should be made through each state and local government's Web sites, as well as in writing to active and deferred vested participants and beneficiaries. [[http://www.tnpgovernment.com/articles/tgov\\_article\\_00023.html](http://www.tnpgovernment.com/articles/tgov_article_00023.html) (Retrieved May 29, 2011)].
- Practices that would increase retirement income payments without regard to material adverse impact on funding should be eliminated, including (but not limited to):
  1. Granting increased benefits with retroactive effective dates. Rare exceptions may be allowed when clearly justified, but only if full disclosure is made to the public, and the exception is subject to taxpayers' voter approval before implementation;
  2. Giving participants "contribution holidays," i.e., temporary suspension of required employee contributions;
  3. Post-retirement public employment programs, such as deferred retirement option programs (commonly called DROPs), in which employees are allowed to continue to work for up to five years after official retirement;
  4. Overly optimistic assumed interest rates in actuarial valuations; and
  5. COLA adjustments. Existing COLA provisions should be renegotiated to be conditioned upon attainment of a funding ratio of 100 percent, and COLAs should be eliminated for new hires.

Elimination of all or a combination of the foregoing practices will establish clear parameters for proper funding, and strengthen the financial integrity of public DB plans.

### Benefit Levels

DB plan benefit levels need to be scaled back when they may replace more than 100 percent of salary at retirement, taking into consideration all sources of income from employer-sponsored supplemental retirement plans. A fundamental change to the overall retirement program is needed if the current DB plan formula is merely designed to maximize benefit payouts regardless of cost, and total retirement income would result in an excessively enhanced standard of living as compared to before retirement.

The "replacement ratio" approach is a rational and disciplined way to properly design DB plan benefit levels. It is based on the philosophy that total benefits from multiple sources under a retirement program for the career employee should be sufficient to provide a standard of living at retirement equal to or about the same as before retirement. This approach avoids the undesirable result of providing a greater standard of living at retirement, which would simply be overly generous, too costly for taxpayers, and therefore unsustainable.

### Replacement Ratio Philosophy

Some public DB plans have been criticized for providing what seem to be overly generous benefit levels. Such criticism is not necessarily justified in every instance. It is important that DB plans provide a level of benefits sufficient for the participant to maintain about the same standard of living during retirement. To do this, retirement programs need to be designed so that participants' earnings just prior to retirement are replaced at an adequate level, while taking into account multiple sources of savings for retirement. What is typically an adequate replacement ratio is about 60 percent for higher-paid employees and about 80 percent for lower-paid career employees. The 60 to 80 percent replacement ratio is a commonly accepted metric. The Missouri County Employees Retirement Fund is an example of a public DB plan that has adopted the replacement ratio philosophy [[http://www.mocerf.org/PensionPlan/Retirement/cpp\\_target\\_replace.htm](http://www.mocerf.org/PensionPlan/Retirement/cpp_target_replace.htm); see also Aon's 2008 Replacement Ratio Study at <http://www.aon.com/about-aon/intellectual-capital/attachments/human-capital-consulting/RRStudy070308.pdf>; also, [http://www.tiaa-crefinstitute.org/articles/rd\\_assetsalaryratio1209.html](http://www.tiaa-crefinstitute.org/articles/rd_assetsalaryratio1209.html) (Retrieved May 20, 2011)]. Best practices may necessitate changing to some form of conservative career average formula, or final pay formula based on highest three years, instead of final highest year.

Pay policies that are strategically developed will motivate employees, and will provide adequate levels of DB plan benefits. Pension boards, reconstituted with objective third party professionals with actuarial and pension benefit expertise, would be well served to adopt the use of a replacement ratio philosophy as a standard guideline. As a general rule, "total replacement ratios" that are required to maintain a person's pre-retirement standard of living are highest for the very lowest paid employees. This is primarily for two reasons. First, before they retire, lower-paid employees save the least and pay the least in taxes as a percentage of their income. Thus, they spend a higher percentage of their income and need higher replacement ratios to maintain that level of expenditures. Second, age- and work-related expenditures do not decrease by as much, as a percentage of income, for the lower-paid employees. This also means they need more income after retirement (as a percent of their pre-retirement income) than the higher-paid employees [<http://www.aon.com/about-aon/intellectual-capital/attachments/human-capital-consulting/RRStudy070308.pdf>]. For example, if a worker was making \$80,000 per year at retirement, and is receiving \$100,000 in retirement income, then the replacement ratio is 1.25 percent ( $100 \div 80$ ). On the other hand, if the same worker was making \$110,000 per year at retirement, then the replacement ratio is 90 percent ( $100 \div 110$ ). Assuming a career of 20 or more years, a replacement ratio of about 80 percent is commonly considered adequate for a retirement plan benefit, based on the premise that many work-related expenses equal to as much as 20 percent of base salary, such as commuting costs, clothing, and meals, are no longer incurred after retirement. To stay within the targeted income replacement ratio, it may be helpful to limit benefit level increases to no greater than cost of living. For example, South Dakota law makes various cost-saving changes affecting post-retirement increases, such as the removal of COLAs for retirees in the first year of retirement [Chapter 20, South Dakota Laws of 2010 (SB 20), <http://blogs.reuters.com/prism-money/2010/12/07/public-pension-laws-need-cleanup/>].

### Pay-for-Performance Concept

Because DB plan benefit levels are primarily determined by pay levels, any reform efforts relating to benefit levels would also need to take into consideration general pay policies. Most state and local governments are, therefore, encouraged to adopt some form of "pay for performance" compensation policies

aligned with the DB plan formulae. The objective is to offer pay and benefits as incentivized rewards for performance, rather than offer entitlements connected to tenure. DB plan formulae based primarily on years of service would be de-emphasized, and replaced by incentives tied to pay, as a means to grow pension benefits. Job security has traditionally been the prime motivational factor for union-employees, as compared to the private sector, although compensation possibly has become the more important bargaining item. Unions may be more familiar with pay systems that reduce inequality between lowest and highest positions. Nonetheless, the pay-for-performance concept should still be an effective incentive for public sector employees. Despite challenges relating to the design and implementation in a nonprofit environment, government employees have already been offered pay-for-performance with some success [[http://www.tmpgovernment.com/articles/tgov\\_article\\_00023.html](http://www.tmpgovernment.com/articles/tgov_article_00023.html) (Retrieved May 29, 2011)].

A recommended first step for government entities with union groups that do not have an existing program is to link pay to specific performance criteria in their individual appraisal process. This is not to suggest that the transition is simple and easy. Well-trained appraisers are still required, and the employees need to be involved in the setting of individual or team goals. Also, important initial questions need to be analyzed and answered, such as:

- Lacking a profit incentives, how are public union employees motivated?
- What makes them work harder?
- How do they wish to be treated?

Lastly, and perhaps most importantly, employees must then clearly understand the objectives and measurable goals of their employer, and how their job performance will contribute toward attainment of the objectives and goals. Therefore, specific government service goals need to be identified and connected to individual performance expectations.

Performance metrics—that is, mechanisms for objectively measuring activities and performance, based on such factors as time, cost, quantity and quality of service or product—can be more closely aligned with the core governmental services provided and the design features of the retirement system. Utah, one of the best-managed states in the country, replaced its DB plan with a 401(k) plan for all new employees in 2010, Nebraska started a "cash-balance" plan

in 1967 (i.e., DB plan with characteristics of a DC plan), and Indiana has a combined DB-DC plan [DC Plans as primary plans: Alaska, Michigan, Minnesota, West Virginia; <http://www.ncsl.org/?tabid=18511>].

Emphasis needs to be placed on incentivizing government employees to be productive, i.e., providing core services that have performance metrics, as opposed to job tenure. The incentive for government employees then becomes superior performance based on identifiable performance metrics in order to earn more salary, which in turn results in greater pensionable earnings for optimum DB plan benefits.

A strategically designed compensation program that incorporates incentive pay enables DB plans to provide a level of benefits sufficient for participants to maintain about the same standard of living during retirement. Rewarding work in the private sector via retirement systems is frequently tied to performance metrics intended to generate income, wealth, and jobs. Performance metrics should be established in the public sector, too, despite the lack of traditional profit motive.

### Switching to DC Plans

During the 1990s, as 401(k) plans became dominant, thousands of DB plans disappeared and many others were "frozen"—meaning that they continued coverage only for existing participants. However, DB plans still have significant liabilities to pay future benefits, along with sizeable assets. As of the second quarter of 2007, the Investment Company Institute reported that state and local government pension plans had \$3.2 trillion in assets and private DB plans had \$2.4 trillion. The bottom line is that the overall cost of retirement systems may be better controlled with DC plans, especially if employee contributions are a prerequisite for matching employer contributions. Long-term employees already in DB plans could have their DB plan benefit "frozen," and start savings prospectively in their own new DC plans accounts, resulting in an attractive "hybrid" program. New employees would participate exclusively in new DC plans.

There are several advantages to switching from DB plans to risk-managed DC plans, including:

1. Opportunities for employee to receive compensation in cash, or as pre-tax contributions;
2. Immediate vesting of employee contributions;
3. Deferral of taxes on investment return, i.e., interest and appreciation, until distribution;
4. Deferral of taxes on employer matching contribution until distribution;
5. Lowering of taxable W-2 earnings from pre-tax employee contributions;
6. Greater control by participants of how savings are invested;
7. Eligibility to "roll over" savings to an IRA or other qualified plan as a nontaxable transaction; and
8. The availability of participant loans (which may be offered in DB plans, but are less common due to actuarial limitations).

### Other Benefit Level Reform Measures

Consistent with the replacement ratio philosophy for retirement programs and alignment with private sector standards, the following are recommendations for the reform of benefit levels of public DB plans:

- Prohibit "spiking," such as adding cashed-out vacation, most leave periods (unless required by federal law, e.g., Uniform Services Employment and Reemployment Rights Act), buybacks upon rehire with interest lower than actual return on plan assets, and other sources of nontraditional pay to calculate—and inflate—DB plan benefits at retirement. For example, the state of California was allowed to "borrow" a federal employee for state employment; and CALPERS (the California Public Employees' Retirement System) attempted to add earnings attributable to prior service as a federal employee in the definition of pay to calculate the CALPERS' DB plan benefits, during the same period of state employment. [E.g., Daniel Francis v. Board of Administrators; CA Case No. 34-2011-80000841; April 28, 2011 (<http://www.pacovilla.com/pdf/FrancisVsKelsoCalPERS.pdf>).]
- Tighten the definition of *compensation* (i.e., "pensionable earnings") eligible for benefit accruals. Special pay intended merely to inflate benefit levels, such as full salary sabbaticals, full pay while on leave to work for union representative, overtime pay, and bonuses should be excluded from the definition. For example, a California State University faculty took leave to work full-time for a union at full salary and the DB plan accruals included that compensation and time. It should be noted, however, that most other unions reimburse California the cost of salary and benefits for such work [<http://www.fresnobee.com/2011/04/23/2361086/release-pay-for-union-work-ar.html>].
- Require participant contributions similar to local private sector plans.



- Modify benefit accrual formulas for new hires by switching to career average earnings from final salary, combined with limits on pensionable salary and benefit caps.
- Raise age for full retirement benefits eligibility to match Social Security's standard, i.e., 67 for those born after 1959. (Narrow exceptions should remain for defined high risk jobs, such as firefighters and policemen where public health and safety are involved. Also, consider extending Social Security to noncovered workers.)

### Collective Bargaining Privileges

By limiting collective bargaining privileges of state, local, and school employees to negotiate only over wages, work performance incentives are improved and traditional conflicts of interest are circumvented. More importantly, however, pension boards and administrators are better able to implement appropriate plan design and operational changes to improve retirement programs.

While recognizing the positive influence of collective bargaining in bringing about improved employee benefits several decades earlier, there is less of a need for union representation in the process today. Nowadays, civil service rules and a myriad of federal and state statutes, and enforcement agencies, already protect government workers. [E.g., 2011 Wisconsin Act 10, et seq., <http://legis.wisconsin.gov/11/Act010.pdf>.] There are over 125 federal and equivalent state statutes that prohibit numerous forms of workplace discrimination, set state and local minimum wages and pay standards, provide paid time off from work, and require safe work environments. The 2011 *U.S. Master Human Resources Guide*, CCH, by D. Myers, lists 64 current federal employment statutes. As of 2011, an equivalent number of state employment statutes exist. Many states have also exercised legal authority by enacting right-to-work statutes, partly in an effort to better control DB plan expenses [1947 Taft-Hartley Act, § 14(b)]. "Right to work" states (i.e., workers have a choice to not join a union before being hired, except most railway and airline industry workers) include Alabama, Arizona, Arkansas, Florida, Georgia, Guam, Idaho, Iowa, Kansas, Louisiana, Mississippi, Nebraska, Nevada, North Carolina, North Dakota, Oklahoma, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, and Wyoming [<http://www.nrtw.org/rews.htm>]. As a result of numerous worker protections, and the trend toward use of participatory management styles in private industry, union

membership as a percentage of the total U.S. workforce has declined precipitously from 67 percent in 1937 to under 12 percent in 2011 [<http://www.unionstats.com/> (Retrieved May 20, 2011)]. Interestingly, the percentage of union members in local, state, and federal government is 36.2 percent as compared to less than seven percent in private industry [BLS 2011].

There are five states where collective bargaining by public employee unions is illegal: Texas, South Carolina, Georgia, North Carolina, Virginia. There are 11 states where forms of collective bargaining are optional. The remaining states require collective bargaining for public employees [<http://www.outsidethebeltway.com/public-employee-bargaining-rights/>]. Most of the states that require collective bargaining prohibit strikes by public employee unions. [See, e.g., State and Local Advisory Reports on Public Employment Labor Legislation: A comparative Analysis; *Michigan Law Review*, 67(5), Mar. 1969; <http://www.jstor.org/pss/1287467>.]

Collective bargaining is governed by federal and state statutes, administrative agency regulations, and judicial decisions. Where federal and state laws overlap, state laws are preempted [U.S. Constitution, Art. VI]. Therefore, there seems to be no federal preemption issue when a state legislature limits collective bargaining privileges of state or local public employees. The National Labor Relations Act of 1935 explicitly excludes all government agencies and their employees from coverage, subject to very minor exceptions relating conditions of employment, except under very rare instances involving small federal entities. [See, e.g., Federal Service Labor-Management Relations Statute; 5 U.S.C. §§ 7101-7135, under which federal government employees are prohibited from using the collective bargaining process, Labor and Employment Law, by D. Twomey (Thomson, 12th edition, pp. 328-329).] Almost half of the state legislatures have already introduced bills that would limit the ability of public employee unions—with the appropriate exception of police and firefighter unions—to negotiate over DB plan benefits. Wage increases would generally be tied to performance metrics, instead of years of service.

### Other Reform Issues

Although the focus of this article is on funding, benefit levels, and collective bargaining, there are other important, related issues, including transparency and disclosure standards, employee attitudes regarding saving, and "phased retirements." They are, however, beyond the scope of this article.

### Conclusion

Ideally, every public DB plan should be fully funded with adequate income replacement for all participants at retirement, and collective bargaining should be flexible, efficient, and without conflicts of interest. However, due to the wide diversity of state and local governments and their different financial

circumstances, attaining this ideal will be challenging. Nevertheless, the foregoing suggestions are offered as objective reform guidelines for pension boards and state and local legislatures. Implementation of these guidelines offers the opportunity to significantly improve sustainability of public DB plans, which will benefit public sector employees and taxpayers in general. ■

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