Working Toward Retirement Security: Policies to Facilitate Employment of Older Americans

The State and Local Government Retirement Benefit Model

Prepared for the Social Security Advisory Board

January 18, 2008

Keith Brainard
Research Director
National Association of State Retirement Administrators

Abstract

Retirement benefits for employees of State and local government often are overlooked or misunderstood in terms of their size, scope, and how they are designed and administered. The prevailing model of retirement benefits for these employees may offer lessons for other segments of the nation's workforce in terms of improving their ability to attract and retain workers, including older employees. This model also may offer lessons with respect to promoting retirement financial security in a cost-effective and sustainable manner.

This paper seeks to describe the public pension landscape in the U.S., with an emphasis on plan design features that promote worker longevity, retention, and employment of older Americans; and on changes to public pension plan design features and federal policies that could foster the employment of older Americans.

Policies aimed at retirement security or extending the working life of older Americans often require a delicate balance. Return to work and phased retirement policies, for example, might work at odds with retirement security for those who reduce their workload and/or begin drawing on their retirement savings sooner than they would have absent such programs. Alternatively, programs that provide employees additional time to work and save for retirement might permit the accrual of additional benefits, as well as delay the need to draw on retirement savings.

NASRA members are the directors and administrators of 82 statewide public retirement systems. Together, these systems provide pension and other benefits for two-thirds of all State and local government employees in the U.S., and hold in trust retirement assets of more than $2.4 trillion.

Key Facts on the Public Sector Workforce and Retirement Benefit Model

State and local government employs 12 percent of the nation's workforce—more than 16 million employees. Retirement benefits for these public employees contrast sharply: in the private sector, the portion of workers with access to an employer-sponsored retirement benefit is 61 percent, and the number with a defined benefit plan (also known as a traditional pension) has shrunk below 20 percent. Among State and local government workers, 98 percent have access to an employer-sponsored retirement benefit, and 90 percent participate in a DB plan.

In 2006, State and local government pension plans distributed more than $150 billion in benefits to seven million retired workers and their survivors, an amount that exceeds the gross State product of 22 States and the District of Columbia. Of the $16+ trillion pool of U.S. retirement assets, combined assets of pension funds sponsored by State and local government comprise some 20 percent, or $3.24 trillion.[1] In addition, employees of State and local government own some $800 billion in defined contribution assets[2], most of which are supplemental to DB plans.

Public employees work in cities and towns throughout the nation, performing a broad array of services in many fields, such as public education, safety, and health; corrections; environmental protection; parks and wildlife management; finance; public transportation; and the planning, design, construction, and maintenance of transportation infrastructure and utilities, including roads and highways, water/wastewater resources, and energy. Nearly three-fourths of the State and local government workforce is concentrated in the areas of education, health, public safety, corrections, and the judiciary.

A recent study of public sector employment found that employees of State and local government have higher educational attainment than the private sector workforce: nearly one-half of public employees hold a college or post-graduate degree, compared to about one-fourth in the private sector.[3] Many public sector positions additionally involve a degree of physical risk not commonly found in the private sector. For example, the nation's "first responders"—firefighters, police officers, other emergency workers, and public health officials—typically are employees of State and local government.

Retention of experienced and trained personnel is critical to the continuous and reliable delivery of vital public services. As such, for both practical and public policy reasons, public sector positions traditionally have been intended by policymakers and employers to be either career-oriented or long-tenured. This long-term emphasis assists public employers by:

- promoting workforce stability through reduced turnover;
- increasing employers' return on investment in employee training, education, and experience, and
- improving the ability of employers to provide quality public services by maintaining a more experienced workforce.

The prevailing public sector retirement benefit model has been designed to induce workers to remain on the job for 20 years or longer, while also providing the financial

---

[1] Federal Reserve of the United States, *Flow of Funds Accounts of the United States, Third Quarter 2007*

[2] Investment Company Institute, *2007 Fact Book*

[3] Stuart Greenfield, *Public Sector Employment: The Current Situation*, Center for State and Local Government Excellence, 2007

security to retire. NASRA supports this system of retirement benefits in the public sector, namely, a defined benefit program to provide a guaranteed benefit and a voluntary defined contribution plan to serve as a means for employees to supplement their retirement savings. Among other reasons, NASRA has cited that the DB plan model is often the best means to i) attract and retain high quality employees by providing stable income replacement in retirement for long-term workers, ii) provide ancillary casualty benefits related to disability and death before retirement; and iii) provide an optimum mix of growth potential and risk in investments, while providing lower administrative expenses and other economies of scale compared to individual account plans.[4]

Pension benefits for employees of State and local government are authorized by State constitutions and statutes, and most public retirement systems are overseen by a board of trustees whose members are a combination of those elected by fellow plan participants, appointed by a governor or other elected official(s), and ex-officio members, such as State treasurers and auditors. Pension benefits for public employees generally are guaranteed and protected by constitutional, statutory, and/or case law.

Unlike corporate pensions, which are preempted from State laws and solely regulated by the Federal government, State and local retirement systems are regulated primarily by State and local constitutions and laws, and must also comply with certain Federal tax and age discrimination regulations. State and local governments have been innovative in designing pension plans, enabling them to meet a variety of stakeholder objectives and changing economic, fiscal, and demographic circumstances. The exemption from a single governance structure has contributed to the creation of a public pension community in which each of the more than 2,500 public retirement systems is unique, with differing benefit plan designs, governance structures, funding methods, and asset allocations, among other features.

Public pension accounting standards, regulated by the Governmental Accounting Standards Board (GASB), have evolved, with the objective of providing information about the financial position and condition of public pension plans and the governments that sponsor them. Retirement systems providing benefits for the vast majority of public employees comply with reporting standards set forth by the Government Finance Officers Association (GFOA). Most public pension plans conduct an actuarial valuation annually, which measures the plan's actuarial experience and required costs. Financial reports for virtually all public retirement systems are independently audited. As a result of these standards and practices, information about public pension assets, liabilities, benefit designs, and related features and characteristics is reliable, accessible and transparent.

Public employees and Social Security

About one-fourth of State and local government workers do not participate in Social Security. When Social Security was first established, constitutional questions arose regarding the authority of the Federal government to tax State and local governments. These constitutional issues were resolved in 1950 when Congress permitted voluntary participation by State and local governments, permitting them to elect coverage for their employees.[5] NASRA supports the affiliation of public pension plans with Social Security on a voluntary basis; however, it opposes mandatory coverage of public employees under Social Security.[6]

---

[4] NASRA Resolution 2003-08, *Support for Defined Benefit Plans*
[5] Rod Crane, *Pensions in the Public Sector*, University of Pennsylvania Press, 2001
[6] NASRA Resolution 1998-03, *Social Security Resolution*

Today, most or substantially all public employees in seven states—Alaska, Colorado, Louisiana, Maine, Massachusetts, Nevada, and Ohio—do not participate in Social Security. Additionally, most or substantially all public school teachers in six other states—California, Connecticut, Illinois, Kentucky, Missouri, and Texas—do not participate. Also, approximately 70 percent of police officers and firefighters throughout the U.S. do not participate in Social Security.

Pension benefits for employees who do not participate in Social Security usually are higher than their Social Security-eligible counterparts: the higher benefit is intended to make up for at least part of the foregone Social Security benefit. All State and local government employees hired since 1984 participate in Medicare.

Since pensions received from work not covered by Social Security may offset Social Security benefits (under the Government Pension Offset and Windfall Elimination Provisions), some argue that such offsets may be a disincentive to older Americans to work in these positions.

Funding levels and actuarial practices

Public sector retirement plans originated at the municipal level in the 19th century and were patterned after the U.S. army and navy pension model.[7] Substantially all public pension plans now attempt to pre-fund the cost of their pension benefits. After slowly and steadily rising for many years, aggregate public pension funding levels grew to 100 percent in 2001. Although this level has decreased to 86 percent, due chiefly to market downturns, public pension funding levels are projected to improve in the coming years as the strong investment returns experienced since 2003 become more fully recognized in pension plan actuarial valuations. About two-thirds of the plans in the Public Fund Survey are funded at 80 percent or higher[8], a benchmark many experts consider to be a sign of a well-funded pension plan.

Funding levels are measured annually for most plans, and rise and fall as actuarial experience, including rates of salary growth, retirement, death, investment return, etc., varies from the plan's assumptions. Funding levels also are affected by the adequacy of contributions. Most plans have a target to attain full funding over a defined timeframe, known as the funding period.

While not every plan has made significant strides toward full funding, a September 2007 study by the Government Accountability Office projected that required additional costs to fully fund public pension obligations is relatively minor:

> A model GAO developed to simulate the fiscal outlook for state and local governments indicates that, for the sector as a whole, estimated future pension costs (currently about 9 percent of employee pay) would require an increase in annual government contribution rates of less than a half percent.[9]

Many plans periodically review their assumptions and adjust them accordingly through what is known as an actuarial experience study. As part of this process, when assumptions are discovered to be significantly different from actual experience, the

---

[7] Clark, Craig, and Wilson, *A History of Public Sector Pensions in the United States*, University of Pennsylvania Press, 2003

[8] The Public Fund Survey is a compendium of state and local government retirement data, sponsored jointly by NASRA and the National Council on Teacher Retirement and accessible at www.publicfundsurvey.org

[9] Government Accountability Office, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs*, September 2007, Report GAO 07-1156

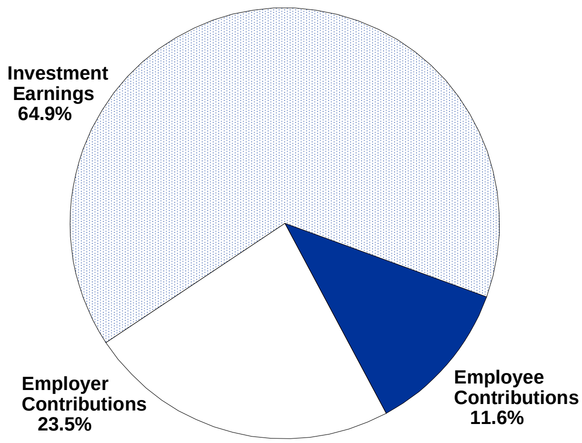
plan sponsor may modify the assumption to comport more closely with experience and anticipated trends.

A large variance in rates of investment return, particularly over several years, can drastically affect—positively and negatively—a plan's actuarial experience and funding level. In order to moderate year-to-year changes in funding levels and required costs resulting from volatility in investment markets, most public pension plans phase in investment gains and losses over several years. This "smoothing" process has the effect of dampening volatility in funding levels and costs.

Public pension revenues: employee contributions, employer contributions and investment earnings

Three sources account for substantially all revenue collected by public pension funds: employee contributions, employer contributions, and investment earnings. As shown in the chart below, investment earnings make up a majority of revenue for the public pension community as a whole.

Figure 1. State and local retirement fund sources of revenue, 1982-2006



Source: U.S. Census Bureau

Unlike most corporate pension plans, most employees of State and local government are required to contribute toward their pension benefit. Employee contributions normally are made as a payroll deduction. The median and most typical contribution rate is 5.0 percent of pay for Social Security-eligible workers and 8.0 percent for non-Social Security-eligible workers.

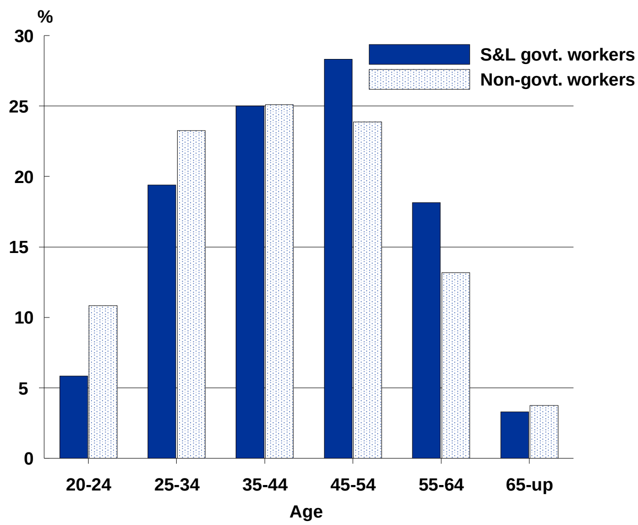
Employer contribution rates vary widely among plans and are subject to change based on actuarial experience and political processes. The median employer contribution rate for plans where participants also participate in Social Security is 8.5 percent, and 11.5 percent for non-Social Security-eligible workers. The cost of pension benefits for some groups, such as firefighters and police officers, are higher because public safety personnel usually have physically demanding jobs with higher risk of death or disability. As such, they usually have shorter careers, longer retirement periods, and higher survivor, disability, and pension benefits compared to most other employee groups.

Policies governing employer contribution rates also vary widely, from fixing rates in constitution or statute, to basing rates on the recommendation of an actuary.

In many respects, State and local governments already accommodate an older workforce

The State and local government workforce is older than the non-government workforce in the U.S. As shown in the chart below, approximately one-half of State and local government employees are age 45 and above, compared to around 40 percent of the non-government, non-agricultural workforce.[10]

Figure 2. Comparison of age distribution of State and local government employees and non-government, nonagricultural employees over age 20



Source: U.S. Bureau of Labor Statistics

Also, as might be expected with an older workforce, employees of State and local government on average have a longer tenure than the non-government workforce, which may suggest that government employers' efforts to retain workers are effective to some degree. A recent study by the Center for Retirement Research at Boston College found:

> While private sector workers have become more mobile over time, the median years of tenure of the public sector workforce have actually increased over the past 30 years. In 2004, the median tenure for state and local employees was 7.7 years, compared to 5.0 years in the private sector.[11]

Plan design features that promote longevity and retention

Public sector DB plans establish eligibility for retirement benefits on the basis of participants' age, years of service, or both. In most cases, to receive a retirement benefit, the participant also must elect to retire and stop working at his or her job. Most public pensions also have a vesting period, with five years being the most typical, although vesting periods among public plans ranges from immediate to 10 years.

Retirement benefits in most cases are based on the employee's salary (usually, an average salary over the final three or five years of employment), years of service, and a calculator, also known as a retirement multiplier. For example, an employee who retires with 20 years of service and a final average salary of $55,000 from a plan with a multiplier of 2.0% will receive an annual, lifetime benefit of $22,000, calculated as follows:

$$\$55{,}000 \times 20 \times 2.0\% = \$22{,}000$$

---

[10] Bureau of Labor Statistics, U.S. Department of Labor, *Employee Tenure in 2006*, September 8, 2006, USDL 06-1563

[11] Munnell et al., ibid.

For general employees and public school teachers who participate in Social Security, the median multiplier is 1.85 percent; for non-Social Security workers, the median multiplier is 2.20 percent. The table below plots salary replacement rates using these median multipliers, based on 10, 20, and 30 years of service.

Table 1. Salary replacement rates at median multipliers for Social Security-eligible and in-eligible workers

	Years of Service		
	10	**20**	**30**
Social Security-eligible median	18.5%	37.0%	55.5%
Non-Social Security-eligible median	22.0%	44.0%	66.0%

Through this design, a defined benefit plan is purposely designed to encourage longevity and retention. The age required to qualify for a retirement benefit varies, but age 60 to 65 with at least five or ten years of service are typical. Some plans use criteria known as the “rule of,” such as the Rule of 80, which permits participants to retire when the sum of their age and service credit equals 80. Still other plans permit retirement at any age once the participant has accrued a required number of years of service credit, such as 20 or 25 for police officers and firefighters, or 25 to 30 for school teachers and other employees.

Because many plans base retirement eligibility on years of service, it is not unusual for a public employee to qualify for unreduced retirement benefits before reaching 60. This is especially true for public safety officers, but, depending on the plan, pertains also to many public school teachers and other groups of workers.

In contrast to most corporate pension plans, which generally do not provide a cost-of-living adjustment to their annuitants, approximately two-thirds of the plans in the Public Fund Survey provide some form of an automatic COLA.[12] Many of those that do not provide an automatic COLA will periodically provide a COLA on an ad hoc basis.

Graduated DB plan retirement multipliers

Some public pension plans offer graduated retirement multipliers, i.e., with factors that increase with attainment of certain age and years of service. Although most DB plans reward tenure through the use of final average or highest average salary formulas, graduated multipliers reward longer service even more than those that are not graduated, and they serve as an even greater inducement for workers to stay on the job longer. Some examples of these graduated multipliers are listed below.

Table 2. Selected retirement plans featuring graduated multipliers

Plan Name	Retirement Multiplier
Alaska Teachers	2.0% for first 20 years; 2.5% for each year thereafter
Arizona State Retirement System	0-20 years of service are multiplied by 2.1%; 20-25 years are multiplied by 2.15% for all years; 25-30 years are multiplied by 2.2% for all years; 30 or more years are multiplied by 2.3% for all years.

[12] Public Fund Survey, ibid.

California Public Employees Retirement System	2.0% at 60 yrs with 5 yrs of service, rising to 2.418% at age 63 with 5 yrs of service
Missouri Teachers	2.5% for first 30 years; for 31 years, 2.55% applies to all years of service
Ohio State Teachers	1-30 years of service are multiplied by 2.2%. 31+ years of service are multiplied by 2.3%, 2.4%, 2.5%, 2.6%, etc.
Rhode Island Employees' Retirement System	1.6% for first 10 yrs, 1.8% for yrs 11-20, 2.0% for yrs 21-25, 2.25% for yrs 26-30, 2.5% for years 31-37, 2.25% for yr 38

Other plan design features intended to promote longevity

Deferred Retirement Option Plans, or DROPs, are a relatively new addition to some public pension plans for the purpose of extending the working life of public employees. Although DROP designs vary, the basic model allows employees who qualify for normal retirement benefits to continue working, typically for a pre-arranged period such as three or five years, while the monthly pension benefit they would have received if they retired accumulates for them in an individual account that is paid to them upon termination from employment. During the "DROP" period, the participant receives a normal salary but does not continue to accrue retirement service credit. The original purpose for DROPs was to create an incentive to keep public safety personnel (police officers and firefighters) on the job longer, and their use remains primarily among public safety plans, although some public pensions with other employee groups have established DROPs.

One example of a DROP designed as a management tool to selectively promote additional service is the one available at the Missouri State Employees' Retirement System. MOSERS participants are not required to apply for or announce their intention to participate in the DROP; rather they simply must work at least two years beyond normal retirement eligibility to qualify for a lump sum payment at retirement. Thus, the MOSERS DROP is referred to as a "BackDROP." Participants may elect to DROP their retirement date back to their earliest eligibility date or five years, whichever is less and they may do so in one-year increments up to the maximum for which they qualify. This arrangement can be particularly attractive for members who qualify for a bridge benefit from the time they reach earliest eligibility for the plan's benefits and the time they qualify for Social Security benefits.

Most public plans require benefits to be paid in the form of an annuity. A small number of plans have added a feature permitting employees to receiving a portion of their benefit as a lump sum, while continuing to have the vast majority of the benefit paid in the form of an annuity. This type of program is sometimes referred to as a partial lump sum option plan, or a "PLOP." A PLOP permits a retiring plan participant to receive a small portion of their retirement benefit as a lump sum, typically with an actuarial reduction made to their annuity. Unlike a DROP, a PLOP is not necessarily intended to extend the working lives of plan participants, but designed properly, a PLOP can create an incentive for participants to work longer.

For example, the PLOP provided by the Mississippi PERS requires participants who meet normal retirement requirements to work an additional three years before they qualify for the PLOP. During the three-year period, participants continue to accrue retirement service credit; at the end of the period, the retiring participant is eligible for a lump sum equivalent of one, two, or three years of their retirement benefit. The retirement annuity is actuarially reduced to reflect the cost of the lump sum payment. This incentive to work longer enables participants to receive a lump sum that can be used for such purposes as paying off a mortgage, retiring other debt, purchasing health care coverage, etc.

Effects on retirement age of health care coverage

While retiree health care is most often a separately administered and funded benefit and is outside the purview of our research, the cost of health care for retirees not yet eligible for Medicare is not insignificant in the formulation of policy options to attract and retain older workers. Employees may be well-served staying on the job longer, taking advantage of their employer-sponsored health care, than they would be if they retired and found they could not afford coverage not subsidized by their employer. Future research on employee health care benefits and their effect on attracting and retaining older workers may provide insight into this issue.

One example of a retiree health care-related benefit that is intended to promote worker retention is in Wisconsin (as well as other States), which gives State employees a credit for unused sick leave toward the cost of retiree health care benefits. This creates an incentive for employees both to preserve sick leave and to work longer. Staying on the job longer reduces the period when employees are not covered by their employer-sponsored plan, but also increases amounts available to finance the cost of their retiree health care benefit.

Phased retirement and return-to-work provisions

Many legislatures have approved a variety of return-to-work provisions, designed to allow retired plan participants to return to work without forfeiting their pension benefit, while also complying with IRS rules regarding in-service distributions. These provisions often are intended to assist employers in meeting shortages of workers, and vary widely in their design.

For example, participants in the Arizona State Retirement System who reach normal retirement eligibility (65 years of age with 5 years of service, 62 with 10 years of service, or the Rule of 80), may return to work for an ASRS employer one year after retirement, as long as there was no agreement with their employer to hire the participant at the time the participant retired. Similarly, ASRS participants who meet normal retirement eligibility criteria may return to work for an ASRS employer without waiting, as long as two criteria are met: 1) there was no agreement between the participant and the employer for the participant to return to employment; and 2) the participant may work no more than 19 hours per week for any length of time, or 20 or more hours per week for no more than 20 weeks per year. Essentially, these provisions are intended to preclude participants from returning to work in a permanent, full-time capacity.

As another example, Connecticut permits former school teachers to receive retirement benefits and to be reemployed by a local board of education or by any constituent unit of the State system of higher education in a position designated by the State Commissioner of Education as a subject shortage area for the school year in which the former teacher is being employed. Such employment may be for up to one full school year and may, with prior approval by the board, be extended for an additional school year.

Although there is concern that such policies might be viewed by some as “double dipping,” as participants receive both a paycheck and retirement check, several factors are placing growing pressure on employers to permit their retirees to return to work. These factors include an increasing retirement rate, as Baby Boomers near retirement age; growing difficulties among employers in replacing retiring workers; employee shortages in certain fields (e.g., teachers and engineers) and geographic areas (e.g. rural areas and inner cities); and increasing employee interest in continuing to work while receiving a retirement benefit.

Another concern, however, is that return-to-work and phased retirement programs do not clearly mesh with Federal pension tax laws or the Age Discrimination in Employment Act (ADEA).

Federal income tax regulations generally do not permit qualified pension plans to pay benefits to participants before retirement. Payments are permitted to participants who are still employed (known as in-service distributions) upon the participant's attainment of normal retirement age or, effective after 12/31/07, age 62. Prior to normal retirement age or age 62, employees must have had a bona fide separation from employment for pension distributions to be made, which specifically excludes employees that are rehired by the same employer in a prearranged manner.

In 2002, the IRS proposed allowing in-service distributions to a participant before normal retirement age under a bona fide phased retirement program. NASRA established a Phased Retirement Committee in 2002 to frame the written comments submitted in response to these proposed regulations (included in Appendix A). Included in the comments was a recommendation that phased retirement regulations not attempt to define normal retirement age for public pension plans, but rather, defer to the State and local statutes governing these plans. Unfortunately, IRS last year released final regulations defining normal retirement age and essentially establishing a one-size-fits-all structure.

State and local government retirement systems are established through public laws by governments acting in their sovereign capacity and subject ultimately to the oversight of popularly-elected governmental bodies and the public. The benefits provided by many public employee retirement systems also are subject to State constitutional or statutory provisions that bar public employers from taking back or reducing system benefits once they have been established. Therefore, NASRA and other organizations again submitted comments urging the IRS to not impose standardized definitions on governmental retirement systems, but instead, to defer to applicable State or local laws, regulations and policies governing these plans.

With regard to the Federal Age Discrimination in Employment Act (ADEA), it is currently unclear how the Equal Employment Opportunity Commission would apply ADEA in the case of a phased retirement or return to work programs. Another recommendation proposed to the IRS by the 2002 NASRA Phased Retirement Committee was that State and local governments should be allowed to protect the value of a participant's retirement benefit during a job that covers the period between career employment and full-time retirement, where the participant might seek reduced hours, lower compensation, or reduced physical or mental stress than career employment. However, it is currently not clear how ADEA would be applied to these concepts.

In fact, the EEOC recently found benefits that bridge a former employee to Medicare-eligibility to be age discriminatory; the EEOC subsequently reversed this finding. The Agency also has charged as age discrimination certain disability programs provided to workers whose careers are cut short due to disability before they qualify for retirement benefits. These types of enforcements create uncertainty for employers as to how the agency would interpret the legality of benefits aimed at older workers who elect to phase out of their career or to simultaneously draw a benefit and a paycheck with younger workers that are in career employment.

Promoting worker longevity and employing an older workforce is not always the same thing

This paper has provided evidence that public employees, as a group, are older and stay on the job longer than their private sector counterparts. This paper also has described the role retirement plan design might play in effecting employment longevity and employee retention. However, longevity and retention do not necessarily translate into employment of older Americans.

As stated above, retirement benefits for many public employees are service-based, rather than age-based, or at least these benefits incorporate length of service into normal retirement eligibility criteria. With the vast majority of State and local government workers in law enforcement and education, there is a high degree of physical risk, physical demands and stress. Serving as a police officer or firefighter is hazardous work with physical demands. Similarly, public school teachers experience stress and burnout after many years of service. State and local governments' public policy objective of facilitating financial security in retirement after a lengthy period of service, enables governments to continue to deliver vital public services with an orderly turnover of workers, and remains a major consideration in retirement plan design for public employees.

State and local government employers that wish to promote employment of older Americans may wish to consider removing certain barriers that may serve as impediments to potential employees. For example, although vesting periods for most public pension plans are five years or less, some plans continue to maintain 10-year vesting. Such a high hurdle of commitment may not serve as an inducement to older workers to work, who may not foresee themselves working long enough to qualify for a retirement benefit.

Retirement plan designs that permit workers to access their retirement contributions, plus interest or investment earnings, and perhaps all or some of their employer's contributions, might induce older workers into public sector positions. For example, terminating participants in the Arizona State Retirement System are entitled to a portion of their employer's contributions, plus interest, to the pension plan beginning at five years of service. The amount participants are entitled to rises with additional service, up to 100 percent with ten years of service or more. Participating electing this lump sum option forfeit their retirement annuity.

Conclusion

Supreme Court Justice Louis Brandeis' description of States as "laboratories of democracy" is surely embodied in the evolving design and administration of retirement benefits for employees of State and local government. This model also enables State and local government to continue to innovate and evolve in the face of changing circumstances.

The State and local government pension community in the U.S. is notable for its size, scope, and diversity of plan design. In certain key respects, the public sector workforce is unique, with a wide range of responsibilities and employees who have a longer tenure than the other workers. Public employers also are different, particularly in that they are essentially perpetual entities that provide benefit protections and long-term sustainability. These features are in stark contrast to other sectors of the U.S. workforce, where plan sponsors may easily terminate their pension plans, or go out of business, be acquired, or file for bankruptcy.

Along with their autonomy with regard to designing, funding, and administering their retirement benefits, and their ability to evolve and innovate in plan designs to meet continuously changing circumstances, these and other characteristics help explain why traditional pension plans in most cases work well for all public pension stakeholders—employers, employees, taxpayers, and recipients of public services.

Some challenges linger, however. Federal tax and age discrimination laws and regulations geared toward corporate plan designs and rules, while perhaps suitable for corporate employers, often are at odds with State and local pension plan designs laws and protections. In addition, a careful balance will be required to ensure return to work and phased retirement policies allow employees to accrue additional benefits and delay drawing down on retirement savings, but do not have unintended consequences, such as encouraging employees to reduce their workload and/or begin drawing upon their retirement savings earlier than they would have absent such programs.

Appendix A

NASRA Letter to the IRS regarding Phased Retirement

Internal Revenue Service
Courier's Desk
Internal Revenue Building
1111 Constitution Avenue NW
Washington, DC

RE: Comments on IRS Notice 2002-43

Ladies and Gentlemen:

The National Association of State Retirement Administrators ("NASRA") appreciates the opportunity to submit comments to the Treasury Department and the Internal Revenue Service regarding phased retirement arrangements under qualified defined benefit plans. NASRA is a non-profit association comprised of the administrators of the state and statewide retirement systems within all 50 states, the District of Columbia, and the four U.S. territories. These systems cover over 10 million participants, retirees, and beneficiaries and hold over $1.5 trillion in assets.

Phased retirement is an area of great interest to our plan participants, the boards of trustees of our systems, and the employers participating in our systems. State and local governments must meet the challenge of phased retirement earlier than the private sector, because their workforce tends to be several years older than the private workforce and their wages are typically lower than in private industry. We have concluded that greater flexibility than is presently available is needed to allow plan sponsors to offer a mix of retirement payments and salary payments in the emerging phased retirement environment.

We commend the Treasury Department and the Internal Revenue Service for seeking comments on this subject, as it is neither an easy nor a non-controversial one to resolve. There are multiple viewpoints regarding the many possible approaches to phased retirement, but after careful consideration of input from NASRA members and evaluation of the various points of view presented, we offer the following response.

NASRA established a Phased Retirement Committee to develop a response to the questions posed in Notice 2002-43. NASRA has adopted six principles on phased retirement which were used to guide the development of this letter. Our comments focus exclusively on state and local governmental pension plans and thus do not address nondiscrimination testing and joint and survivor rules.

<u>Principles for Phased Retirement</u>

1. **Good retirement planning for some individuals means avoiding an abrupt termination of work and, instead gradually transitioning into a retirement that meets their social and economic needs. These programs are called “phased retirement” or “transitional retirement.” They are pre-retirement work arrangements that permit an individual to move from his/her career position to a position of reduced hours, lower compensation, or reduced physical or mental stress. These do not include programs that allow a retiree to return to work.**

Greater flexibility is needed in federal guidance and tax laws to allow states and local governments to create programs that address the phased or transitional retirement needs of their employees. NASRA believes the following factors argue for flexibility in retirement approaches:

- Employers are seeking ways to retain experienced employees, as the slower rate of growth in the number of workers entering the workforce is projected to result in a growing labor shortage. The concentration may be in certain geographic areas, certain professions or positions, or certain employers.

- Employees are working longer. The long-running trend toward an earlier retirement age (especially a permanent "no-work" retirement) has stopped and may have begun to reverse. However, employers are not legally positioned to increase the retirement eligibility age for present employees.

- Retiree medical costs are increasing at a rate that makes it necessary for employees to work at least enough hours to maintain group health coverage until they are Medicare eligible. Availability and affordability of health insurance is a major driver of when employees retire.

- The Social Security retirement age is gradually increasing to age 67, which may motivate workers to further defer their retirement dates.

- A growing consensus exists that the nature of retirement is changing. Many workers no longer wish to experience a sudden end to work, followed by an equally sudden onset of full-time retirement. Instead, many workers wish to ease into retirement, transitioning out of the workforce with a reduced workload and/or the flexibility to work a different schedule.

- Two years ago, Congress approved the elimination of the Social Security earnings test for persons age 65 or older, freeing older retirees to work and earn as much as they wish without losing Social Security benefits.

- Social Security is increasing the delayed retirement credit that serves as a reward for delaying initial benefit receipt past the normal retirement age. This credit will increase from three percent per year of benefit delay to eight percent by 2008.

- The Phased Retirement Liberalization Act was introduced in Congress in 2000. This bill would have permitted defined benefit pension plans to make in-service distributions at the earliest of age 59½, 30 years of service, or the pension plan's normal retirement age. Although it did not pass, the bill is a sign of Congressional interest in accommodating employers and employees seeking flexible work/retirement arrangements.

- An increasing number of retirees face financial burdens, requiring them to continue working. The disastrous performance of the equity market for the last two years also has directly affected many members' retirement planning. Losses of over 20% of the value of their supplemental deferred compensation accounts and/or tax sheltered annuity accounts have caused changes in projected dates of retirement and type of retirement (with continuing work in some capacity being a growing financial reality).

2. **Every retirement system is different in design. Thus, IRS activity in the area of phased retirement should allow retirement systems to have such programs.**

   Additional flexibility in payout options should be granted to permit variable payouts over the lifetimes of plan participants, including in-service distributions for members who meet early or normal retirement criteria. Currently, minimum distribution rules and premature distribution rules prohibit or discourage this flexibility. Also, the 10% premature distribution penalty should be modified so that the "substantially equal" test would still be met if the payments were made part of a plan's phased retirement program.

3. **Any IRS activity in the area of phased retirement must recognize that retirement systems have different funding methods and varying levels of funding. Accordingly, IRS should not adopt any policy that would require retirement systems to assume additional funding obligations.**

   NASRA members have differing views regarding in-service distributions. Some systems believe that in-service distributions are inherently counter to the system's purposes. Some of these systems are concerned that if the IRS permits in-service distributions, particularly without requiring a corresponding decrease in workload or a limited return to service requirement, the system could be financially harmed. Other systems believe some limited exceptions would be helpful and would like to see the IRS clarify that if a system elects to do so (but with no mandate to do so), it may allow in-service distributions once a person is eligible for benefits as defined under that system. What NASRA members can agree on is that the IRS should not adopt any policy that would require states to assume additional funding obligations. Time limits on any experiments in the phased retirement arena should also be permitted so that governmental plans are able to sunset them or only use them in conjunction with a window program. Any IRS guidance should not impose the concept of "vesting" on these programs.

4. **IRS should clarify that the definition of such terms as normal retirement age, early retirement age, minimum retirement age, and final or highest average compensation (or whatever term is used in a particular jurisdiction) should be whatever appears in the applicable state or local laws, regulations, case law, and policies governing the retirement system. Such clarification serves to recognize that state and local governments have different ways of defining these terms.**

There is strong consensus among NASRA members that the IRS should not attempt to define early or normal retirement age. There is a wide range of retirement criteria in place, and it would be inappropriate, unpopular and counterproductive for the IRS to attempt to develop a standardized definition. Trying to "lock down" standard definitions would be an impediment to state efforts to address employer staffing and experience needs as well as employee financial needs as they transition to retirement. The IRS should not attempt to create standardized definitions for early or normal retirement age, but instead should defer to the applicable state or local laws, regulations and policies governing a particular plan

5. **Distribution of benefit should only be made after an individual is eligible for a retirement benefit or allowance.**

   Phased retirement structures should only contemplate distribution of benefits after an individual is eligible for a retirement benefit, using whatever age and/or service the plan design requires. NASRA also does not believe it would be appropriate for the IRS to attempt to define what workload reductions, etc. would be required to allow in-service distributions.

6. **Any phased retirement program should allow state and local governments to protect the value of a participant's retirement benefit during a "bridge job." A "bridge job" is a position that offers reduced hours, lower compensation, or reduced physical or mental stress than career employment and covers the period between career employment and full-time retirement. It is also called a transitional job.**

   Although we realize it is not under the jurisdiction of Treasury or IRS, the EEOC should be encouraged to review its rules with respect to phased retirement since it is currently not clear how the ADEA should be applied to these concepts.

Current Framework for Retirement

We thought it might be helpful to provide an overview of how NASRA systems are currently structured. The provisions of most of our systems are either wholly or in significant part established by state legislatures. Virtually all "plan documents" are public record. Those two facts obviously distinguish us from most private sector plans where plan provisions are established by individual employers in the context of ERISA. Our systems generally have hundreds if not thousands of employers (cities, counties, towns, state agencies, public schools, universities, etc.) who are either statutorily mandated into the state system or who may elect to cover their employees in the state system. Regardless of which approach is used (mandated or elective), once in, employers generally must cover all eligible employees, perhaps with some statutory exclusions. According to the US Census Bureau, in 1999-2000 there were more than 2,200 state and local government employee retirement systems covering fourteen million active employees and five million retirees. Ninety percent of these system members participate in defined benefit pension plans. Membership in public pension plans is concentrated in a relatively small number of retirement systems, with the largest seventy-five retirement systems representing more than 80% of all public retirement plan participants. Of these largest systems, 56 are NASRA members.

General Observations on Phased Retirement

The concept of "retirement" and the needs/wants of older workers in retirement are changing. If we, as pension administrators, are to meet those needs with innovative and creative ideas, we cannot be restricted by thinking only in terms of "the way we have always done it."

Because no two governmental retirement systems are exactly alike, it is critical for federal tax laws and guidance to be structured with as much flexibility as possible to allow state and local governments to address phased or transitional retirement needs of their employees as they see fit. Any guidance should be permissive, in that systems (and their legislatures) should have the right to develop plan provisions that are the most appropriate for their participants. For instance, public systems vary greatly regarding what constitutes normal retirement age as well as in the area of return-to-work latitude. Some legislatures have chosen to limit ability to work and receive full pension benefits, while others have traditionally been much more flexible, and others are moving into broader approaches to adapt to changing demographics and needs for skilled workers. Therefore, no single phased retirement approach would be appropriate for all governmental employers.

Each state should be able to create a program that meets its needs and too many restrictions will make this difficult. With the high cost of health insurance and the many budget cuts facing state governments, there may be instances where a state finds that unfettered consideration of phased retirement can work to the advantage of employers and employees. There are also actuarial considerations to take into account when offering post-retirement employment with no clear definition of how long the employment can last, which may result in some states choosing to limit the "phased" period or not offer it at all. Individual states are best positioned to look at the cost implications, the human resource needs, and the "cultural" expectations of such a program. This will also provide an "idea pool" of creative approaches to situations that may be prevalent in several systems.

We also recognize that in some cases there will continue to be a desire to have very limited availability of phased retirement, e.g., only a window of opportunity or only certain types of employees (e.g., teachers). There will invariably be periodic mismatches between the demand for talent and the pool of available talent that can be attracted to employment. It would not be wise to address these periodic mismatches by making changes to the underlying design of a retirement plan that is, for all practical purposes, achieving broad policy objectives. However, through a change in or clarification to the historical policy regarding partial work, management could be empowered to address short-term personnel needs by tapping the retired population in filling critical positions where temporary workforce shortages exist.

NASRA believes that in some states, the policymakers will decide that they want to allow gradual transitions to retirement. In those states, the policymakers will consider pre-retirement work arrangements designed to permit employees to move from his/her career position to a position of reduced hours, lower compensation, and/or reduced physical or mental stress. NASRA believes that any phased retirement structure should only contemplate distribution of benefits after an individual is eligible for a retirement benefit, using whatever age and/or service the plan design requires. As noted earlier, the IRS should not attempt to restrict plan design, but simply defer to the applicable state or local laws, regulations and policies governing a particular plan.

In closing, we thank you for soliciting comments on these very important issues. We applaud the Service's willingness to consider whether federal actions in this area are appropriate, and we would be pleased to meet with you to discuss these issues further. Please feel free to call me at (xxx) xxx-xxxx; our Phased Retirement Committee Chair, Laurie Hacking at (xxx) xxx-xxxx; or our director of federal relations, Jeannine Markoe Raymond at (202) 624-1417.

Very truly yours,

Frank Ready, President
National Association of State Retirement Administrators