Chapter 41

The Public-Sector Environment

Introduction

More than 21 million individuals are employed by public jurisdictions in the United States. These public entities include the federal government; state, county, and municipal governments; school districts; and a host of other special-purpose districts and authorities. Approximately 16 percent of the employed labor force, or nearly 1 in 6 working Americans, works for a public entity.[1]

Nearly all of these public employees are covered by employee benefit programs. While there is enormous diversity among the programs, taken together, they exhibit a certain family resemblance and differ in important respects from private-sector programs. This chapter highlights these differences and provides an overview of the current status of employee benefits in the public sector.

Many of the differences between public-sector and private-sector benefit plans stem from the different environments in which they operate. Indeed, these environmental differences are important enough that some discussion of them is necessary to provide a context for understanding the differences in individual benefits.

Centrality of the Political Process

The single largest difference between public- and private-sector benefit programs lies in their relationship to the law and the legislative process. All qualified private-sector plans with tax-incentive features are regulated by the federal government (primarily by the Employee Retirement Income Security Act of 1974 (ERISA)), but public-sector plans are not subject to all ERISA provisions. Within these constraints, private-sector plan sponsors are relatively free to establish, maintain, and modify their plans as regulated by ERISA.

By contrast, the basic features of public employee plans—eligibility, contributions, types of benefits, etc.—are often spelled out in statutes or in local ordinances. Even where collective bargaining over benefit issues is allowed,

[1] Data are preliminary for October 2006 from U.S. Department of Labor, Bureau of Labor Statistics.

the legislatures generally retain some measure of control. Furthermore, public employee programs usually exist within a highly structured personnel system that is itself prescribed, often in great detail, in public law. In addition, because they are legislative products, public employee benefit plans necessarily reflect the interplay of political (rather than economic) forces. Where public employee benefit plans are concerned, the interest group activities can usually extend far beyond the public administrators and employees (and their unions and associations) that are directly affected, and often include provider groups, insurers, the business and financial community, and taxpayer organizations.

The influence of organized labor on public employee benefits is particularly strong. In 2006, approximately 40.1 percent of public employees were represented by labor unions, compared with 8.1 percent of private employees (U.S. Department of Commerce, 2008). This influence is exercised directly where bargaining over benefit issues is allowed, but it is also exercised indirectly through the legislative process.[2]

Relationship to Federal Law

A second fundamental difference in the environment of public employee plans as opposed to those sponsored by private companies is the role played by federal tax and benefits law and regulation. The taxing power of the federal government has been used to encourage the provision of employee benefits by private business since 1916, when corporations were first allowed to deduct payments to retired employees, their families, and dependents as ordinary and necessary expenses (Graebner, 1980). The federal government's taxing power has also been used to compel certain behavior (e.g., participation in Social Security) by the levying of payroll taxes. However, approximately one-fourth of all full-time workers in state and local defined benefit plans are not covered by Social Security (Fore, 2001; Eitelberg, 1999).[3]

Regarding federal taxation, it should be recognized that a qualified private-sector pension plan and its participants enjoy three tax benefits. First, the employer's contributions are immediately deductible. Second,

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[2] There continues to be quite a range of union influence or lack thereof—on one end there are states that have public-sector collective bargaining with binding arbitration where benefits are on the table and the other end of the spectrum would be right-to-work states or states that simply have "meet and confer" statutory provisions. Regardless of the union influence, the legislative process through which benefit provisions are established has much in common with the collective bargaining process.

[3] Among general coverage statewide retirement systems, 43 systems participate in Social Security. The delineation between states with systems under Social Security and those outside the system is not entirely clean, however, since there are both large and small retirement programs not covered by Social Security that operate in states where the general retirement programs are covered.

earnings on the plan investments are exempt from taxation. Third, the benefits in the pension plan that accrue to participants are tax-deferred until the participant takes a distribution. By contrast, because state and local governments are not subject to federal tax, the first benefit is inapplicable to them. In the second benefit, earnings on plan investments may or may not be tax-deferred—depending on whether the plan invests in tax-exempt state and local government investments (in which case there would be no tax benefit) or any other taxable investment (in which case the earnings would be exempt from taxation until distributed). Therefore, the only benefit applicable is the third one that defers a participant's liability for federal tax on the pension accrual until he/she takes a distribution. Since public jurisdictions are not taxpaying entities, their behavior cannot be influenced by opportunities to reduce federal tax on their revenues.

State and local jurisdictions also co-exist with the federal government in a system of federalism, and while the powers and prerogatives of the various levels of government have changed over time, the balance among them is always a politically delicate issue. The federal government has at times formally asserted that its tax laws and benefits regulations do apply to benefit plans for public-sector employees, but occasionally its enforcement has been slow. However, public-sector plans share with qualified private-sector plans a common source of rules under the federal Internal Revenue Code (IRC), which has been expanded in recent years. Attention to public plans has increased in the last several years, however (see chapter on defined benefit plans). For reasons unrelated to federalism, the federal government has also chosen to exclude its own employees' benefit programs from major parts of the law applicable to private plans. The special status of governmental plans can be seen most readily in their relationship to two landmark pieces of federal legislation, the Social Security Act of 1935 and ERISA.

Benefit Systems

The pension area for state and local jurisdictions is characterized by a relatively small number of large systems and a large number of small systems. According to the U.S. Census Bureau, there were 2,654 state and local retirement systems in the United States as of 2006, with the 221 state-administered systems accounting for 90 percent of the total covered population (U.S. Department of Commerce, 2006). At the federal level, most civilian employees are covered by the Civil Service Retirement System (for civil servants entering the federal government before 1984) or the Federal Employees Retirement System (for new hires brought in after 1983). Those in the military services are included in the Defense Department's military retirement system. Approximately another 30 relatively small groups—e.g., staff employed by the Foreign Service and Federal Reserve and other bank systems—have their own, entirely separate, arrangements.

Health and life insurance plans are likely to be operated by each jurisdiction for its own employees and, unlike pension plans, they are often collectively bargained. However, New York and California operate statewide health benefit programs in which local government employees can elect to participate. Where they exist, state-run long-term disability and sickness and accident insurance plans may also be open to local government entities.

Occupational Divisions

Another salient feature of public employment for benefit purposes is that the work force in some states is subdivided along certain occupational lines. In many jurisdictions, law enforcement and firefighting employees have their own programs apart from those for other public employees. Alternatively, they may participate in a general system but in plans that take into account their unique career patterns. Public school teachers also sometimes have separate plans or separate arrangements, whether they participate in a state-run or a local plan. The special status of these occupational groups is partly historical (they were among the first to obtain pension coverage), partly a consequence of the occupations' characteristics and requirements, and partly a reflection of their ability to protect their interests in the political arena.

One characteristic of private-sector plans that is extremely rare in the public sector is the provision of separate benefits for executives. In the public sector, benefit provisions tend to apply equally to all levels of the work force. Even where separate "executive services" have been recognized, separate benefit provisions are rare. However, this egalitarian tradition does not extend to members of the judiciary, the legislature, or elected members of the executive branch. Since careers for legislators and elected officials may encompass a much shorter period of time than for other categories of employees, plan provisions for these occupations may allow benefits to accrue at a faster rate. Judges almost always have their own separate pension plans, typically with higher benefit accrual rates, while legislators enjoy faster pension vesting, eligibility, and computation provisions. The judges' plans are justified on the grounds that the judiciary must be provided a sufficient measure of security to allow them to carry out their responsibilities in an impartial, disinterested way and also because they typically enter the system at a late age. The special provisions for legislators and elected officials are justified by the uncertain nature of their tenure.

Key Distinguishing Characteristics

It is quite unusual for private-sector employees to contribute to defined benefit retirement plans. While not universally true, a common characteristic of public-sector pension plans is the requirement that members, as a condition of employment, must contribute to the cost of their defined benefit retirement benefits. The typical approach is to require that a certain percentage of payroll be contributed. A provision of the IRC, which is applicable only to public-sector plans, allows for the establishment of an arrangement whereby member contributions may be made with before-tax dollars—an arrangement that has been widely embraced in the public sector.

Another distinguishing characteristic is public employee participation in Social Security. While private-sector employees are universally covered by Social Security, public-sector employee participation is dependent on whether or not the state in which they work has an agreement with the federal government for state and/or local government employee coverage. In a few states, no public-sector employees participate in Social Security, and in many states certain segments of the public-sector work force (such as teachers, police, and fire employees) are excluded, while the balance of the public employee work force participates.

Commonalities

For all the differences between public- and private-sector employee benefit plans, there also are numerous commonalities. In a competitive marketplace, all employers need to attract and retain workers and to maintain a healthy and vigorous work force. To the extent that benefit programs serve these needs, they are based on common motives and directed at common goals. Furthermore, while public pension systems developed early and more or less independently of private business practice, the later addition of health and welfare plans was often a response to the availability of such benefits in private employment. Indeed, in determining many aspects of compensation for public employees, legislators have looked to practices prevailing in the business community. Thus, many developments in private-sector employee benefit plans eventually surface in public employee programs, albeit in a form tailored to the public entity's traditions and circumstances.

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