Fundamentals of Employee Benefit Programs

PART FIVE
PUBLIC SECTOR
Chapter 41
Regulation of Public-Sector Retirement Plans

Introduction

Like their private-sector counterparts, public-sector pension plans—representing federal, state, and local jurisdictions—are extensively regulated by the federal Internal Revenue Code (IRC), the common source of rules governing the deferral of taxation for each type of pension plan. In fact, this regulation has been significantly expanded in recent years. In exchange for the deferral of taxation and for certain other favorable tax treatment, the IRC sets forth certain pension plan requirements some of which apply to both government and private-sector plans and others from which government plans are exempt.

In addition to IRC regulations, public-sector plans operated for employees in state and local jurisdictions are extensively regulated and governed by state constitutional, statutory, and case law. These plans are highly regulated, and in the past three decades the states have voluntarily adopted regulations, procedures, and practices—legal, actuarial, accounting, administrative, and investment—that have led to strong, responsible, and effective public employee retirement systems (PERS) across the country.

Because of their well-developed benefit programs, the significant size of assets (approximately $3 trillion at the end of 2001), and their large numbers of active and retired members (24 or more million individuals), public-sector pension plans are naturally the subject of interest to all stakeholders involved in their operation, including public employers; employer associations; plan members and employee organizations; taxpayers; legislators on the state, local, and federal level; and, last but not least, beneficiaries.

Federal Regulation of State and Local Plans

Public pension plans operated for federal employees are largely exempt from practically all of the rules applicable to other plans. Somewhat differ-

---

1 Public-sector pension plans, known as “governmental plans” in ERISA, refer to a plan established or maintained for employees of the federal government, states and their political subdivisions. While other organizations (e.g., international organizations) are included under this heading, we limit the discussion in this chapter to federal, state, and local jurisdictions. See Chapter 1 of Calhoun and Moore (2002) for more details.

2 For background on federal law regarding the taxation of public retirement systems, see Calhoun and Moore (2002).
Public pension plans are operated at the state and local levels, which are regulated largely by state and local law, but federal regulation of these plans has been evolving. State and local pension plans are governed by state constitutions and laws that historically provided public-sector workers with relatively stronger guarantees than could be found in the private sector. States protect retirement benefits of public employees through some combination of the following: statute, common law, and/or constitution. Since state constitutions involve procedures that make amending them a lengthy and detailed process, they can be viewed as being stronger than other types of protections in the law (Moore et al., 2000).

Passage of the Employee Retirement Income Security Act of 1974 (ERISA) required private-sector retirement plans to satisfy minimum coverage, participation, vesting, funding, and fiduciary requirements as a means of improving retirement income security for plan participants. When ERISA was enacted, Congress intentionally excluded government pension plans from certain sections of the act “... in order that additional information might be obtained regarding whether a need exists for further regulation” of these plans (U.S. Congress, 1978). ERISA called for a congressional study of several aspects of government pension plans, including the adequacy of their financing arrangements and fiduciary standards. That study, The Pension Task Force Report on Public Employee Retirement Systems, was completed four years later and reported certain deficiencies in public plans in the areas of funding, reporting and disclosure, and fiduciary practices. Later that same year, the federal government imposed reporting and disclosure requirements on pension systems for its own employees (Employee Benefit Research Institute, 1997).

Nearly three decades later, however, state and local government plans still enjoy a general exemption from many requirements of ERISA. ERISA includes a group of provisions under the IRC, all of which apply to private plans and many of which apply to governmental plans. It also has provisions enforced by the Department of Labor, from which state and local government plans are exempt. But while many ERISA provisions do not always apply to retirement plans of state and local governments, those requirements may indirectly influence plan design and administration in areas ranging from investment and fiduciary standards to pension rights of surviving spouses.

---

3 See U.S. Congress (1978). The 1985 Public Employee Pension Plan Reporting and Accountability Act (PEPPRA) was a similar (but unsuccessful) attempt to create a public-sector version of ERISA.

4 Where ERISA rules do not apply, comparable state laws do, such as in the case of vesting and funding.

5 Sections of ERISA that do apply to public-sector plans include Title III and significant sections of Title II. Government plans are exempt from most of ERISA's reporting, disclosure,
Moreover, although public-sector plans are excluded from several sections of ERISA, these plans are required to comply with pre-ERISA requirements of the IRC. These pre-ERISA requirements thus continued to shape the plan qualification rules for both private- and public-sector plans in the years following the establishment of ERISA.⁶

Some observers continue to believe that state and local plans would benefit from the federal imposition of ERISA-like standards. Underfunded plans can be found (primarily at the local level), although state and local public pension systems have traditionally been generally well financed. A 2000 study by the Public Pension Coordinating Council concluded that, “...state and local government employee retirement systems are well funded and in sound financial health” (Zorn, 2000). According to that study, 84 percent of all systems conducted actuarial valuations on an annual basis, and 98 percent conducted them at least every two years. More recently, in 2004, a Public Fund Survey report on public retirement systems found that funding ratios had declined since their peak in 2001, and that approximately 80 percent were underfunded (Brainard, 2004).

**Tax Laws and Public-Sector Plans**

After the passage of ERISA, the enactment of a series of tax and other federal laws, beginning in the mid- and late-1980s, further affected the legal framework of employment-based benefit plans (Crane, 1999; Harris, 2000). Unlike ERISA, many of these provisions do apply to state and local plans. This expansion into the operations of state and local pension plans, found in many federal tax and civil rights protection laws by 1990, began to lessen the ERISA-nonERISA distinction.

For example, the IRC sec. 401(a)(17) limit on compensation applied to governmental plans through a grandfather rule. The regulations governing the Sec. 401(a)(17) annual compensation limit ($150,000) generally took effect on January 1, 1996. As indexed, this limit was raised to $170,000 in 2001 and then increased in 2002 to $200,000 under the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 (Calhoun and Moore, and funding requirements (Title I) and plan termination insurance (Title IV). See Chapter 1 of Calhoun and Moore (2002) for details.

⁶ When Congress enacted the Taxpayer Relief Act of 1997 (TRA ’97), which provided full relief from the nondiscrimination rules for state and local governments, it continued a tradition dating back to 1977. In 1999, the Internal Revenue Service (IRS) issued Notice 99-40, which provided relief from compliance with the nondiscrimination rules for certain governmental plans, other than plans maintained by a state or local government (e.g., federal government agencies, international agencies, and Indian tribes) until January 1, 2001. IRS Notice 2001-46 extended this compliance date until the first day of the plan year beginning on or after January 1, 2003.
Most public employee retirement plans are contributory, and the Tax Reform Act of 1986 (TRA ’86) replaced a special “three year recovery” of contributions rule that had applied primarily to public employees. Where public employees had earlier been granted up to three years of tax-free benefit payments to recover their own post-tax investment in pension plans, TRA ’86 stipulated that their benefits were to be treated as partly taxable and partly tax free, based on an “exclusion ratio.” Furthermore, if those employees received a preretirement starting date distribution, even if the distribution equaled their accumulated contributions, it would be treated as partly a tax-free return of contributions and partly a taxable distribution. The ratio of the tax-free to the taxable part of the distribution would reflect the ratio of the total employee contributions to the total value of the plan’s expected benefits.

TRA ’86 also recognized that public employee plans provide normal retirement benefits at an earlier age, on average, than most private-sector plans due to the inclusion of public safety employees. The IRC Sec. 415(b) benefit limitations apply, although Sec. 415 (b)(2)(F) provides special protection for governmental employees by substituting age 62 for the Social Security normal retirement age. Specifically, governmental plans were allowed to remain under pre-TRA ’86 Sec. 415 limits regarding maximum benefits and actuarial reductions for retirement before a specified age.

Because retirement at younger ages is common in the public sector, compliance with the new, more severe Sec. 415 rules would have forced some public jurisdictions to reduce benefits to current employees below promised amounts, violating pension plan law and in some cases constitutional law that prohibits cutbacks in public employees’ benefits. Special Sec. 415 rules were also enacted for police and firefighters, who typically retire at younger ages than other public workers. Because some state and local plans had promised benefits even beyond those allowed under pre-TRA ’86 limits, an additional option was provided under the Technical and Miscellaneous Revenue Act of 1988. This law allowed jurisdictions to “grandfather” and excuse any Sec. 415 violations resulting from benefit payments made to employees who became plan members before January 1, 1990, although the jurisdiction had to apply the new Sec. 415 limits applicable to private plans to all future plan members.

A series of federal laws since TRA ’86 have continued a trend toward extending coverage of federal legislation to state and local pension plans. For example, the Omnibus Budget Reconciliation Acts (OBRA) of 1990 and

---

7 The Small Business Job Protection Act of 1996 modified the Sec. 415 limits in such a manner that the 100 percent of compensation limit does not apply to governmental plans.

8 See Harris (2000) for a discussion of the history and development of Sec. 415 limits and their relationship to public-sector plans.
Chapter 41: Regulation of Public-Sector Retirement Plans

1993 required employees not covered by a retirement plan to be covered by Social Security, and imposed mandatory 20 percent withholding and direct rollover rules, respectively. Also, the Small Business Job Protection Act of 1996 (SBJPA '96) required IRC Sec. 457 plan assets and income to be held in a trust, custodial account, or an annuity, and modified Sec. 415 limits to exclude their application to public-sector plans. Another federal law, the Taxpayer Relief Act of 1997 (TRA '97), liberalized service purchase contribution Sec. 415 limits for public-sector plans, granted a permanent moratorium on the application of IRC nondiscrimination rules for state and local governmental plans, and permitted in-service distributions of amounts of $5,000 or less payable under an IRC Sec. 457(b) provision under certain conditions.

More recently, passage of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 has had an impact on public-sector plans. First, EGTRRA enhanced the portability of participants in governmental pension plans in a number of ways. For example, beginning in 2002, it permits the use of Sec. 403(b) and Sec. 457 assets to purchase service credits in public-sector defined benefit (DB) plans through the transfer of funds (direct trustee-to-trustee exchange) to a governmental DB plan. Also, EGTRRA eases restrictions for eligible rollover distributions (but only through a direct rollover) among qualified retirement plans, Sec. 403(b) annuities, individual retirement accounts (IRAs), and governmental Sec. 457 plans, including the rollover of after-tax amounts, as surviving spouses will now also be able to roll over distributions to a qualified plan, 403(b) annuity, or 457 plan in which their spouse participates. In addition, the law repeals

---

9 Legislative interest in Sec. 457 plans was sparked in 1994 by the losses of 457 plan participants in Orange County, California, in the country’s largest municipal bankruptcy in history. Authorities arbitrarily reduced employee retirement accounts by 10 percent—permitted at the time because plan accounts were managed by the county and technically considered county property—to resolve a severe budget shortfall, leading to a lawsuit filed by county employees. This well-publicized event led to a SBJPA '96 requirement that all amounts deferred by a state or local government employer be held in a trust (or custodial account or annuity contract) for the exclusive benefit of employees (Olsen, 1996). This requirement gave 457 plan participants the same protections as 403(b) and 401(k) plan participants. Prior to that time, the funds deferred by governmental employees into a 457 plan were subject to the claims of employer creditors. Non-education 457 plan participants were ineligible for coverage under 403(b) plans and also state and local governments were prohibited from creating new 401(k) plans after TRA '86. Thus, non-education state and local government employees had no way to save for retirement on a supplementary basis except through a 457 plan, which lacked the protections of similar plans.

10 Under state and local law, employees are commonly allowed to purchase service credit as a means to boost pension benefits and recover credit for years of work that would otherwise be lost because the employee was not eligible to receive a benefit at work. For example, at the state level, most public school teachers can purchase out-of-state teaching service. Interstate as well as intrastate reciprocity, where retirement systems are authorized to transfer participant’s credit to other retirement systems, is sometimes available (Moore 1999b).
the “same desk rule” for 401(k), 403(b), and 457(b) plans—replacing the words “separation from service” in Sec. 401(k)(2)(B) with “severance from employment”—thereby allowing employees to roll over their accounts in their prior employer’s plan to their new employer’s plan or to an IRA.

A second area influenced by passage of EGTRRA deals with contribution and benefit limits. The law increases the annual elective deferral dollar limits for 401(k) plans, 403(b) annuities, and 457 plans to $11,000 in 2002, $12,000 in 2003, $13,000 in 2004, $14,000 in 2005, and $15,000 in 2006, respectively, and indexes them thereafter. It also affects compensation-based DC plan limits by increasing the dollar limit on annual additions under Sec. 415(c) from $35,000 to $40,000, indexing them in $1,000 increments thereafter; and increases the 25 percent of compensation limit on DC plans to 100 percent. Regarding compensation-based DB plan limits, it increases the Sec. 401(a)(17) DB compensation limit from $140,000 to $160,000 at age 62, with late-retirement adjustments for benefits starting after age 65, then indexes them in $5,000 increments thereafter. EGTRRA also allows catch-up contributions to 401(k), 403(b), and governmental 457 plans for participants who are age 50 or older, up to $1,000 in 2002, $2,000 in 2003, $3,000 in 2004, $4,000 in 2005, $5,000 in 2006, and indexed thereafter. Also, the law increases the Sec. 401(a)(17) DB compensation limit to $200,000 from $170,000 and indexes the limit thereafter in $5,000 increments. In addition, EGTRRA repeals the 403(b) exclusion allowance applicable to contributions to Sec. 403(b) annuities; henceforth, such annuities are subject to the limits applicable to tax-qualified plans. The law also increases the 33 1/3 percent of compensation limits on deferrals under 457 plans to 100 percent. Finally, EGTRRA repeals the coordination of Sec. 415 and Sec. 457 limits.

A third area affected by passage of EGTRRA concerns IRAs. EGTRRA increases the annual dollar IRA contribution limits from the old limit of $2,000 to $3,000 in 2002, to $4,000 in 2005, and higher in future years. Beginning in 2003, 401(k) and 457(b) plans were allowed to permit employee contributions to separate accounts or annuities and to elect to treat the contributions as IRAs or Roth IRAs; then, beginning in 2006, 401(k) and 403(b) plans will be permitted to allow participants to designate a portion of their elective deferral as a Roth contribution.

Other pension provisions are also affected by EGTRRA. First, a federal income tax credit is now available to low-to-moderate-income individuals that matches part of the salary-reduction contribution of individuals with incomes below $50,000. This includes those who participate in 401(k), 403(b), or governmental 457 plans, or in IRAs, of up to $2,000 with the size of the credit declining from 50 percent to 10 percent as income increases. Another EGTRRA provision addresses the tax treatment of 457 plan assets in divorce proceedings. The provision applies the tax rules for qualified plan distribu-
tions, according to a qualified domestic relations order (QDRO), to 457 plans, and clarifies that the plan does not violate any restrictions on distributions when making payments to an alternate payee under a QDRO. EGTRRA also allows for the exclusion from the employee’s gross income for tax purposes of any retirement planning services generally provided to employees by an employer maintaining a qualified employer plan.

**State and Local Regulation**

As mentioned, any analysis of state and local retirement programs must begin with a recognition that these systems operate in a legal environment that is partially subject to state rules and regulations but often falls under federal law and regulations. Although federal initiatives in regulation have occurred, the development of plan features and management of plan operations still rely extensively on state and local laws and regulations. Constitutional and contractual law guarantees, which may be expressed in state statutes and decisional law, afford members of public employee retirement plans many of the protections granted to members of ERISA-regulated plans by federal statutory law. In fact, it is safe to say that public employees have stronger protection than private-sector employees today. A private-sector company can simply do away with its pension plan—subject to Pension Benefit Guaranty Corporation rules—merge, or terminate. This does not happen in the public sector because of the strong legal guarantees in place.

In those instances where ERISA rules are not applicable to public plans, such as reporting and disclosure, it is interesting that public plans are adopting the rules (through their state legislatures and through compliance with public pension industry standards) on a voluntary basis. By contrast, state statutes most often spell out benefit formulas, age and service requirements, and vesting and contributions and typically include ancillary provisions such as disability and death benefits. In effect, these statutes constitute a “plan document” that contains the plan provisions of a private-sector plan.

---

11 A qualified private-sector pension plan and its participants enjoy three tax benefits: First, the employer's contributions are immediately deductible. Second, 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.
Many states have also established pension commissions. In fact, New York had established a successful commission as early as 1971, and by the late 1980s, permanent pension commissions and legislative retirement committees had been formed in 21 states, temporary commissions had been formed in three states, and legislative committees with pension activities had been formed in three states. These commissions and committees were formed for the purpose of providing guidance to public executives, administrators, and legislators in developing public retirement objectives and principles, identifying problems and areas of abuse, projecting costs of existing systems and modifications to those systems, and designing and implementing pension reform programs (Foster Higgins, 1988). In some cases, the pension commissions also oversee nonpension benefit programs (e.g., by studying the costs of providing postretirement medical coverage for public employees) and serve as a buffer between the legislature and special interest groups. States without a separate retirement or pension committee tend to handle these issues under the jurisdiction of the state finance or ways and means committee. According to the National Conference on State Legislatures, approximately 21 states operated permanent pension committees in 2002.

**Governance and Funding**

Administrative responsibility of public-sector plans varies by level of government. In the federal government, the primary civilian retirement systems, Civil Service Retirement System and Federal Employees Retirement System, are administered by the Office of Personnel Management with assistance from federal agencies, while the retirement system for the military services is administered by the Department of Defense. Among state and local jurisdictions, operating within a statutory framework, a board of trustees establishes the overall policy for administering pension plans, which can include adopting actuarial assumptions (DB plans), establishing procedures for financial control and reporting, and the setting of investment policy.

Investment policy also varies with the level of government. Among most state and local jurisdictions, the investment policy for the $2.3 trillion in assets managed by these retirement systems is governed by state or local statute. Most states incorporate “prudent person” rules, which require that investments be made with the care of a prudent individual, solely in the interest of plan participants, echoing ERISA’s definition of the prudent person principle. A number of states also have “legal lists” of permissible or prohibited investments, percentage limits on certain types of investments, or rules covering diversification of pension assets. For example, some states limit the percentage of assets that can be invested in equities (perhaps to
50 percent or less), while other states permit allocation of a percentage of assets to in-state investments (occasionally defined as a percentage in residential mortgages). Other common investment restrictions include limiting the maximum amount of assets that can be placed in one company, in foreign stocks or bonds, or in real estate. Local pension plans have utilized legal lists to a greater extent than do plans operating statewide (Harris, 1998). Although there has been a marked decline in their use, at least 20 state retirement systems were subject to legal lists in 2000 (Moore, 2000). During the past two decades, many jurisdictions have broadened permissible investment opportunities for their pension plans, allowing them to prudently pursue a higher return for participants and employers. While public pension funds invested 95 percent of their assets in bonds in 1950, this share had declined to 33 percent in 2001. Meanwhile, the investment in equities increased from one percent in 1950 to 60 percent in 2004 (Brainard, 2004).

Public pension plans have been largely successful in increasing returns through these changes. With a notable pool of assets, public plans are facing issues such as the propriety of using public pension fund investments to further social goals. More recently, some state and local funds have begun to concern themselves with the governance of the companies in which they invest. Such investor activism can be viewed as another strategy by pension trustees to ensure that plan participants enjoy higher returns for the associated risks (Useem and Hess, 1999). A related issue is the active encouragement of certain types of investments within the same jurisdiction as the retirement system. Anticipated benefits from such economically targeted investments (ETIs) include job creation, infrastructure, and the like.

**Conclusion**

Public pension plans have been substantially strengthened by federal, state, and local laws and regulations over the past several decades. In many instances, these new rules have applied to both public-sector and private-sector plans. Due to their strong constitutional and statutory guarantees on the state level, employees’ rights and benefits may have even greater protection today in the public sector than is available for workers in the private sector. This backdrop of legal statutes, governance, and tradition all combine to play a role in defining a public-sector culture shaped by the continued presence of professional pension administrators, informed legislators, and government administrators involved in the public pension policymaking process.
Bibliography


Additional Information

American Academy of Actuaries
1729 Eye Street, NW, 7th Floor
Washington, DC 20006
(202) 223-8196
www.actuary.org

Government Finance Officers Association
180 North Michigan Avenue, Suite 800
Chicago, IL 60601
(312) 977-9700
www.gfoa.org

National Association of State Retirement Administrators
P.O. Box 980
Georgetown, TX 78627
(512) 868-2774
www.nasra.org