

# Social Security Privatization

March 17, 1999 SSP No. 16

## ***State and Local Government Retirement Programs: Lessons in Alternatives to Social Security***

*by Carrie Lips*

### **Executive Summary**

Approximately five million state and local employees are exempt from Social Security and instead participate in retirement plans administered on the state and local levels. The history of those retirement plans provides valuable information for policymakers attempting to reform the federal program.

State and local retirement plans generally provide plan participants with more benefits and greater flexibility over retirement age and plan payout than does Social Security. Those state and local plans can provide superior benefits because they predominantly "prefund" future benefits, either by saving and investing the program's income or by allowing the participants to save and invest their contributions in accounts

that will provide for their own future benefits. Prefunding also provides security for future retirees: while Social Security is facing a severe shortfall in revenue, most state and local plans are fiscally sound and, in many cases, thriving.

Defined-contribution plans, such as the city of San Diego's, are evidence of the feasibility of a system based on mandatory individual investment. Participants in those systems enjoy market rates of return on their contributions and have ownership of their retirement income, which means they do not face the risk that the government will decide to cut their benefits. State and local defined-benefit plans demonstrate the financial benefits of a funded system, but show that there is a danger, when government invests, that political pressure will influence investment practices.

**The success of the defined-contribution plans described in this study demonstrates the feasibility of a mandatory retirement system based on individual investment.**

## **Introduction**

When President Franklin Delano Roosevelt signed the Social Security Act into law in 1935, the program covered some private-sector workers and excluded state and local government employees. At that time Congress was concerned about the constitutionality of the federal government taxing state governments.<sup>1</sup> State and local government workers remained outside the Social Security system until 1950, when the act was amended to allow states to provide Social Security coverage to those employees who were not already covered by a public retirement system. By 1954, this provision had been broadened to allow state and local governments to provide Social Security to all of their employees regardless of whether they were already covered by a public retirement system. Even so, state and local government agencies were allowed to opt out of the Social Security program until 1983, when the law was changed to prevent them from leaving the federal retirement program.<sup>2</sup> However, those systems that had never entered the program or had opted out prior to 1983 were able to remain outside Social Security.

Today, approximately 5 million workers, who have annual salaries totaling roughly \$132.5 billion, remain outside the Social Security program.<sup>3</sup> Those workers participate in retirement programs that are administered at the state and local levels.

Those state and local retirement programs vary in their structure, financing, and benefits. While such plans exist throughout the country, 75 percent of the income earned by individuals exempt from Social Security taxes can be found in seven states: California, Colorado, Illinois, Louisiana, Massachusetts, Ohio, and Texas.<sup>4</sup> Individuals in those programs work in a variety of government jobs; among the largest groups are teachers and law enforcement officials.

Although the details of those state and local retirement programs vary, the participants in the programs generally receive greater benefits and enjoy more flexibility than do participants in Social Security. State and local plans can provide superior benefits because they predominate “prefund” future benefits, either by saving and investing the program’s income or by allowing the participants to save and invest their contributions in individually owned accounts. State and local plans also attempt to meet the specific needs of their employees and

provide individuals with more flexibility regarding retirement age and method of benefit payments.

The success of the defined-contribution plans described in this study demonstrates the feasibility of a mandatory retirement system based on individual investment. The defined-contribution plans offer participants greater returns and individual ownership of their retirement savings. In addition, defined-contribution plans avoid some of the problems associated with defined-benefit plans, such as political influence on investment selection.

Some policymakers view state and local workers as a potential source of revenue for the Social Security system and recommend mandating that all newly hired state and local government employees participate in Social Security. However, closer examination of state and local programs reveals that those programs are more than just a potential source of FICA taxes (Social Security payroll taxes). They provide useful information about the benefits and hazards of some aspects of retirement programs—information that should guide the debate about the future of Social Security.

Instead of jeopardizing state and local workers’ retirements by forcing them into Social Security, policymakers attempting to reform Social Security should work to incorporate into the federal program the best elements of the state and local retirement plans by moving toward a system of individually owned and privately invested personal retirement accounts (PRAs).

## **State and Local Government Non-FICA Retirement Plans**

There are two types of state and local retirement programs: defined-benefit and defined-contribution plans. The majority of state and local government workers are covered by defined-benefit plans run by their employers. However, as this study will indicate, the defined-contribution plans that do exist are very successful and provide valuable information on the feasibility of administering a reformed, defined-contribution Social Security program.

Defined-contribution and defined-benefit plans differ in who controls the program’s assets and how benefits are determined. In both cases, participants (and/or their employers) are required to pay a percentage of their salaries to the

program, as in the Social Security system. Although contribution rates are often divided between employers and employees, overwhelmingly economists recognize that the full cost of benefits is borne by the employee since the share contributed by the employer would have otherwise been passed on to the employee in the form of compensation.

In defined-contribution plans, the money that is contributed by and on behalf of the plan participant goes directly into an account that is the property of the individual. Throughout the participant's life, the contributions amass and earn additional revenue. At retirement, plan participants use the assets in those accounts to provide benefits.

In defined-benefit plans, contributions generally go to the program to be used at the plan manager's discretion—to pay current beneficiaries or as savings for future benefit payments. Benefits received by participants are not directly related to the amount they have contributed or that the employer has contributed on their behalf. Instead, benefits are determined by formulas that typically take into account the worker's salary, length of service, and, sometimes, age at retirement.<sup>5</sup>

Some state and local retirement programs give beneficiaries the option of different benefit payment structures, but typically retirement benefits take the form of lifetime annuities, providing beneficiaries with monthly checks.

Unlike Social Security, most state and local retirement plans allow participants to retire before age 65 and receive full benefits. Defined-benefit plans generally impose a minimum service requirement or require that the combination of the worker's age and years of service reach a set sum.<sup>6</sup> That additional flexibility on retirement age is an important feature of those plans, especially since many of the participants are in high-stress jobs like law enforcement or fire fighting.

Almost all state and local programs provide disability and survivor insurance.<sup>7</sup> A wide range of benefit levels is provided. In defined-benefit plans, surviving spouses often receive an annuity equal to what the worker would have been entitled to if retirement had occurred on the day prior to death. Long-term disability benefits are typically 60 percent of earnings.<sup>8</sup> Survivor and disability benefits often require that participants work a set span of time before becoming eligible for benefits.

At retirement, workers participating in defined-benefit plans are also often given a choice regarding the extent (or existence) of survivor coverage. Retirees can select a plan that fits their life situation: if single and childless, a retiree can save money by choosing a plan without a survivor benefit. In defined-contribution plans, the assets in the plan participant's account are inheritable.

The overall performance of the many state and local programs that cover employees outside the Social Security system is difficult to quantify. However, studies have been conducted that provide broad findings on the merits of state and local government programs in comparison to Social Security.

William E. Even and David A. MacPherson conducted a study published by Third Millennium comparing seven non-FICA defined-benefit retirement plans with Social Security.<sup>9</sup> The seven retirement systems analyzed were selected to represent a wide range of plans in terms of membership, geographic location, and state versus local administration.<sup>10</sup>

This study found that the non-FICA plans replace a significantly higher percentage of pre-retirement income than does Social Security. They estimated that for a given earnings history the average non-FICA pension paid a benefit between 3.3 and 7.5 times the annual benefit of Social Security.<sup>11</sup>

These general findings are supported by a 1994 study conducted by the Department of Labor, which surveyed employee benefit plans in state and local governments and obtained representative data for 15 million employees.<sup>12</sup> That study provides broad findings about the benefits typically provided by state and local retirement programs and includes information on workers who are outside the Social Security program.

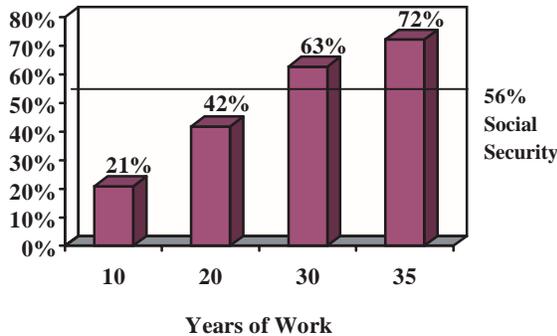
As shown in Figure 1, except for workers with the fewest number of working years and the lowest salaries, the non-FICA retirement plans provide a higher replacement rate than does Social Security.

These findings, which indicate that Social Security's retirement benefits are less than those provided by other defined-benefit programs, are confirmed again in a study conducted by the General Accounting Office (GAO). The GAO analyzed the potential effects on state and local retirement plans and participants in those plans if the law were changed to mandate that all state

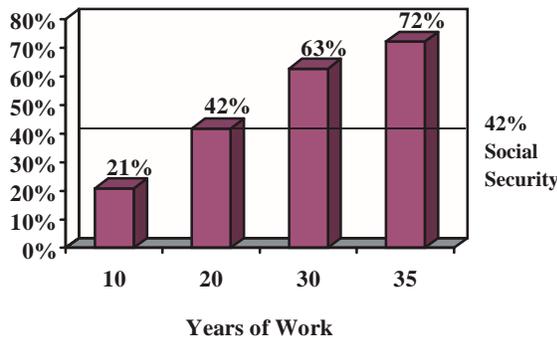
**In defined-contribution plans, the money that is contributed by and on behalf of the plan participant goes directly into an account that is the property of the individual.**

**Figure 1**  
**Comparison of Average Income Replacement Rates for Workers by Specified Final Earnings and Years of Service for Retirement at Age 65, under Non-FICA State and Local Retirement Plans and under Social Security**

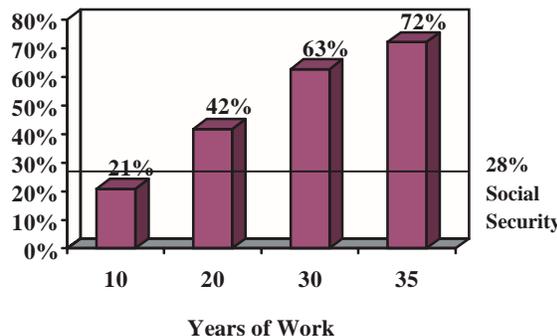
Replacement Rate for a Worker with Final Average Earnings of \$15,000



Replacement Rate for a Worker with Final Average Earnings of \$35,000



Replacement Rate for a Worker with Final Average Earnings of \$65,000



Source: U.S. Department of Labor, Bureau of Labor Statistics, "Employee Benefits in State and Local Governments," p. 124; and House Committee on Ways and Means, 1998 Green Book, p. 4.

and local workers must participate in Social Security.

Cynthia Fagnoni, director of the GAO study, testifying before the House Ways and Means Committee on the conclusions reached in the study, stated that the "impact on public employers, employees, and pension plans would depend on how states and localities with non-covered employees would react to these new coverage provisions."<sup>13</sup> However, she also stated:

Costs would likely increase for those states and localities that wanted to keep their enhanced benefits for newly hired employees. Alternatively, states and localities that wanted to maintain level spending for retirement would likely need to reduce some pension benefits.<sup>14</sup>

Clearly, the finding that individuals who are currently outside of Social Security would receive fewer benefits or would have to pay more if forced to participate in the federal program suggests that the state and local programs are a better value than Social Security.

The discrepancies between the benefits provided by Social Security and those provided by state and local programs mostly stem from differences in the systems' methods of financing. Because both Social Security and state and local defined-benefit plans determine benefits by a set formula, the financing of the programs does not have direct consequences for participants. For example, whether the manager of a program invests a worker's contributions in equities that earn a 10 percent rate of return or immediately spends the worker's money will not affect the participant's promised retirement benefits. However, the long-term viability of any retirement plan depends on the soundness of its financing. State and local programs that have prefunded future benefits, and thus taken advantage of market forces, have been able to adopt more generous benefit formulas and do not face the potential shortfall forecast for Social Security.

Even and MacPherson highlight the implications of the two methods of financing for the future of the programs:

The Social Security system's pay-as-you-go structure presents a major dilemma as the ratio of retirees to workers increases over the next fifty years. In the non-FICA

plans, liabilities are funded in advance to avoid this problem. Moreover, the non-FICA plans have earned a higher rate of return on the investment of these funds than has the Social Security system. The non-FICA plans have been able to take advantage of the fact that historically higher returns have been earned in the equity markets than in bond markets.<sup>15</sup>

According to the Public Pension Coordinating Council (which surveys state and local government retirement systems and provides summary analyses), state and local plans generally invest their funds in accordance with the state and local laws that regulate investment decisions. This prefunds future benefits and provides additional revenue for the system, which reduces the need for future employee and employer contributions.

Although the experience of state and local governments with investing in stocks and bonds demonstrates the benefits of prefunding and the power of compound interest, it also provides a warning concerning how political interests can guide investment selection.

The Public Retirement Institute conducted a study on the trends in investment restrictions that govern public pensions. The study found that while broad restrictions are easing, specific restrictions are increasing:

While most public retirement systems are now subject to prudence standards rather than legal lists, specific restrictions and encouragements are increasingly affecting the individual investment decisions of the systems. . . . In the last year, restrictions from investing in stocks were lifted from the final three state retirement systems: West Virginia, Indiana, and South Carolina. In that same time, several states have considered or adopted restrictions on investments in tobacco and gangsta rap company stock. Also, some jurisdictions have considered ways in which the public pension system could bolster the economy.<sup>16</sup>

Approximately 42 percent of state, county, and municipal pension systems have restrictions targeting a portion of investment funds to projects designed to bolster the local economy.<sup>17</sup> Twenty-three percent of pension systems pro-

hibit investment in specific types of companies for “moral” reasons.<sup>18</sup> The dangers of those types of investment practices are serious: they can expose the program participants to unnecessary risk and introduce the possibility of corruption and cronyism.

Alan Greenspan, Chairman of the Federal Reserve, has testified about the dangers of allowing the federal government to invest and cited the experience of public pension funds as an example:

The experience of public pension funds seems to bear this out. . . . it has been shown that state pensions plans that are required to direct a portion of their investment in-state and those that make economically targeted investments experience lower returns as a result.<sup>19</sup>

Several studies confirm the negative impact of economically targeted investments (ETIs) on investment returns. A September 1995 Joint Economic Committee report states emphatically: “Among state-level public pensions, where ETIs have been attempted, the evidence clearly demonstrates that ETIs reduce the rate of return on pension investments.”<sup>20</sup> That study cites a paper written in 1983 by Alicia Munnell, who found that “ETIs are associated with a 2 percentage point reduction in investment returns.”<sup>21</sup>

The Joint Economic Committee’s report includes numerous examples of state pensions that have lost substantial sums of money due to poorly performing ETIs—from the Kansas Public Employees’ Retirement System, which lost \$65 million investing in a Kansas-based Home Savings Association, to a Pennsylvania retirement fund that invested in a \$70 million Volkswagen plant that lost 57 percent of its value over 14 years.<sup>22</sup> However, the economic consequences of ETIs and other politically motivated investment strategies are not limited to pension participants; they also affect the general economy:

Although the evidence presented above has dangerous implications for America’s pension system, there are consequences beyond just pension plans. According to standard economic theory, optimal economic growth requires the efficient use of all resources, including capital. If capital is diverted to less productive uses, economic

**The non-FICA plans have earned a higher rate of return on the investment of these funds than has the Social Security system.**

**If attempts to “bolster the economy” similar to those applied by many state retirement plans were applied with the resources of Social Security, there would be severe effects on the efficiency of the market.**

growth will be slower than it would be otherwise. . . . The potential for ETIs to harm the nation’s economic growth is considerable: by forcing pension funds to finance less productive investments, the whole economy will suffer. The long run slowdown of economic growth caused by the ETI-induced misallocation of capital will depress income growth and the standard of living.<sup>23</sup>

The dangers associated with states and localities investing in the market and selecting investments according to a political agenda are minor compared to the dangers of giving the federal government the same powers.

The total assets of state and local retirement systems in the United States amount to slightly more than \$2 trillion.<sup>24</sup> Those assets are spread throughout the country and are invested under the laws of various jurisdictions. The experience of those systems with private investment provides a warning for those who would have the federal government invest the Social Security Trust Fund in private equities and bonds. President Clinton proposed in his State of the Union address to allow the federal government to invest in stocks; under his proposal, the Social Security Trust Fund would contain, in 1999 dollars, \$743.5 billion in stocks in the year 2025.<sup>25</sup> If “restrictions and encouragements” and attempts to “bolster the economy” similar to those applied by many state and local retirement plans were applied with the resources of the Social Security Administration, there would be severe detrimental effects on the efficiency of the market.<sup>26</sup>

Defined-contribution plans avoid such problems since individuals own the program assets and investment decisions are not controlled by the state.

### **Some Specific Examples**

While an overview of state and local retirement plans shows that they are more financially sound and provide better benefits to their participants than does Social Security, it is helpful to look at programs individually in order to isolate the characteristics that are most beneficial and that may provide the most useful information for policymakers attempting to reform and improve the federal program.

### **The City of San Diego**

In 1981, the city of San Diego made the decision to opt out of the Social Security program. At that time, the cost of Social Security was expected to rise and the city believed that a retirement program set up independently could provide a better “cost-benefit ratio.”<sup>27</sup> San Diego designed the Supplemental Pension Savings Plan (SPSP), a mandatory defined-contribution program, to replace Social Security for city employees.<sup>28</sup>

Today, approximately 8,000 individuals participate in San Diego’s SPSP program. Employees of the city of San Diego are required to contribute 3 percent of their salaries to their SPSP accounts. Employees hired before July 1986 have the option of contributing an additional 4.5 percent of salary, and those hired after that date may contribute an additional 3.05 percent of salary.<sup>29</sup> The city of San Diego matches 100 percent of the employee’s contribution, including the voluntary portion. As of October 1997, only 161 of the 2,463 participants who were eligible to contribute 4.5 percent of their salaries were not taking full advantage of the opportunity; of the 5,430 who were eligible to contribute 3.05 percent, only 893 were not doing so.<sup>30</sup>

When the program was first set up in 1981, all contributions were invested by the city treasurer in low-risk investment products such as U.S. government securities and money markets. In October 1996, individuals were given control of their investment selection.

Today, each employee has the option to invest the assets in his or her account in a combination of five funds. The funds represent various levels of risk. On the low-risk end is the Managed Income Fund, comparable to the fund managed by the city treasurer prior to the change in 1996. This fund consists of stable value contracts, primarily securities of the U.S. government. At the high-risk end is the Templeton Foreign Fund, which consists primarily of non-U.S. stocks. There is also a fund made up primarily of stocks from the Standard and Poor’s (S&P) 500 and a fund that uses a mix of stocks and bonds.

As a part of administering the program, the city of San Diego attempts to educate program participants about investment strategy. Today, they provide employees with a pamphlet that not only includes information specific to the program but also educates employees on the

basic principles of investing.<sup>31</sup> If employees fail to make a selection, their money is invested in the lowest-risk managed income fund. Currently, about 50 percent of the assets of SPSP participants are held in that fund.

Employees are fully vested in their mandatory and voluntary contributions, which means that if an employee terminates employment he retains ownership of that portion of the assets in his account. Participants become fully vested in the city’s match of mandatory and voluntary contributions at 20 percent intervals per year of employment. After five years, a participant has full ownership of all the assets in his account.

If a participant terminates employment before retirement, he has the option of rolling the pre-tax portion of the account into an individual retirement account (IRA) or leaving the assets in the SPSP and continuing to invest with the program. If an individual chooses instead to access those funds, the portion that was not previously subject to tax—the employer match and the capital gains in the account—will be taxed.

Participants may take out a loan of up to 50 percent of the value of the account assets in which they are vested, up to \$50,000. The minimum loan amount is \$500. Participants have up to five years to repay the loan at an interest rate that is fixed for the term of the loan and is determined by the city of San Diego, based on the shared secured loan rate of the San Diego Municipal Credit Union. Participants generally repay their loans through payroll deductions. If loans are not repaid, they are treated as a disbursement and subject to taxation. More than 2,000 participants are currently using the loan provision.<sup>32</sup>

After working for two years, any participant in the program may withdraw contributions and earnings once per year. Participants who are not fully vested in the city’s contributions forfeit that portion of their accounts, which ranges from 100 to 20 percent depending on vesting level. Participants are not allowed to access the city’s contributions until retirement or termination of employment, even after they are vested. Approximately 700 members per year access a portion of their funds.<sup>33</sup>

Plan participants are able to access their retirement funds without paying a penalty tax at age 55 if they are eligible for retirement (which requires a minimum of 20 years of service); otherwise, they can access their funds at age 59.5.

Participants may choose in what manner they would like to receive their benefits, including a full cash payout. They may also choose not to access their funds and to let the funds continue to grow. In the event of a plan participant’s death, the full value of the account is paid to a designated beneficiary.

In 1981, San Diego also provided its employees with a long-term disability plan guaranteeing employees 70 percent of their biweekly income if they are unable to perform “duties of regular occupation” and “light duty.” After the first year of disability, payments continue if the employee is so disabled that gainful employment is not possible. An employee must have worked for 12 months prior to becoming disabled unless the disability occurred on the job, in which case workers’ compensation benefits are provided. The cost of the disability program is born by the city of San Diego.

As shown in Table 1, the San Diego SPSP has provided individuals with a market rate of return on their contributions. The lowest-risk managed income fund has provided an average nominal rate of return of more than 8 percent over the past 15 years.

The effects of this rate of return on individual participants are significant. Consider, for example, a San Diego employee who was first employed in 1982 at age 22, contributed the

**The San Diego SPSP has provided individuals with a market rate of return on their contributions. The lowest-risk managed income fund has returned more than 8 percent over the past 15 years.**

**Table 1**  
**San Diego SPSP—Nominal Rates of Return of the**  
**Lowest-Risk Managed Income Investment Fund**

Year	Rate of Return (%)
1982	15.49
1983	9.75
1984	11.17
1985	10.49
1986	8.61
1987	7.71
1988	7.75
1989	8.83
1990	8.30
1991	7.69
1992	7.21
1993	5.03
1994	4.51
1995	5.82
1996	5.52
1997	6.69
1998	6.52
<b>Average</b>	<b>8.06</b>

Source: San Diego SPSP Plan administrator.

**The cumulative effects of participating in the program instead of Social Security over an entire working lifetime are even more dramatic.**

minimum of his \$30,000 salary to his account while working, and kept all his money in the lowest-risk managed income fund. Today, at age 39, he would have approximately \$60,000 in his account.<sup>34</sup> If he had also taken advantage of a portion of the voluntary option and made a contribution of 12 percent, which is comparable to what he would have paid Social Security, he would today have almost \$120,000 saved for his retirement.

The potential benefits for plan participants who are now given the opportunity to control their own investment selection are even greater. As shown in Table 2, three of the four new investment funds offered by SPSP since 1996 have provided average annual returns well above 10 percent. If the aforementioned plan participant who has been contributing 12 percent of his salary to his account had moved his assets to the AIM Constellation fund in 1996 when he was first given the opportunity to control his investment selections, his assets would have grown to more than \$150,000.

The cumulative effects of participating in the program instead of Social Security over an entire working lifetime are even more dramatic.

Consider, for example, an individual who begins working for the city of San Diego at age 30 and works for 35 years for a salary of \$30,000. Assume that he contributes just the minimum to his SPSP account and earns a 7 percent real rate of return (the average real rate of return for U.S. stocks from 1926 through 1996 was 7.56 percent).<sup>35</sup> At retirement, he would have an account worth \$266,244 in today's dollars. According to the plan administrator, that account today could provide a lifetime monthly payment of \$1,802 to a single male retiring at age 65. It could also provide a plan participant who has a spouse of the same age with a joint-survivor annuity paying \$1,568 per month.<sup>36</sup>

Even if a more conservative annuity estimate is used, such a plan participant could receive a monthly payment of about \$1,026.<sup>37</sup>

If the city employee described above were to take advantage of the voluntary contribution and pay closer to what Social Security takes out of most workers' paychecks, his benefits would be \$532,488. According to the plan administrator, that could provide a monthly annuity of \$3,605 for a single man or a payment of \$3,136 that would continue during the lifetime of a spouse of the same age. The more conservative annuity estimate would result in a monthly benefit of approximately \$2,052.

If this worker were required instead to participate in Social Security, he would be entitled to receive a monthly payment of approximately \$1,077 after paying 12.4 percent of his income to the program. As shown in Figure 2, even when SPSP participants contribute just the minimum to their accounts, they still can expect to receive more in retirement benefits than they would have from Social Security.

San Diego's SPSP provides an example of how a mandatory system based on individual investment can be successfully administered. The program provides its participants with more freedom and control over their retirement savings and allows individuals to enjoy market rates of return.

**The Alternative Plan for Galveston County Employees**

The Galveston County Alternative Plan also originated in 1981, when three counties in Texas voted to opt out of the Social Security program.<sup>38</sup> The Galveston County commissioner brought in a financial consultant to help design the plan and specified that it must provide benefits that, at a minimum, were equal to the benefits provided by Social Security for the same cost.<sup>39</sup> Today, there are approximately 1,500 participants in the Galveston Alternative Plan.<sup>40</sup>

Galveston County employees hired after 1987 contribute 6.13 percent of their earnings to their "retirement annuity accounts," which are administered by a financial services company. The county also contributes 7.785 percent, less the cost of disability and survivor insurance, to participants' accounts.<sup>41</sup>

When the program was being designed, there was concern about market risk. Those crafting

**Table 2**  
**Nominal Rates of Return on SPSP Investment Funds**

Year	Rate of Return (%)			
	Templeton Foreign Fund	AIM Constellation Fund	American Express Trust Equity Index Fund	IDS Mutual Fund
1996	18.00	16.27	22.72	13.63
1997	6.65	12.92	32.90	18.90
1998	-4.88	18.89	28.49	9.46
<b>Average</b>	<b>6.59</b>	<b>16.03</b>	<b>28.04</b>	<b>14.00</b>

Source: San Diego SPSP administrator.

the program decided that, in order to address these concerns, all mandatory contributions would be invested with a single financial services company in a vehicle with a fixed return. The selection of the company was determined through a bidding process, and the contract was awarded to the company that would provide the highest fixed rate of return.<sup>42</sup> As Table 3 shows, the average yearly nominal rate of return received on this risk-free investment has been approximately 8.64 percent.<sup>43</sup>

**Table 3  
Nominal Rate of Return on Assets in the Galveston Alternative Plan**

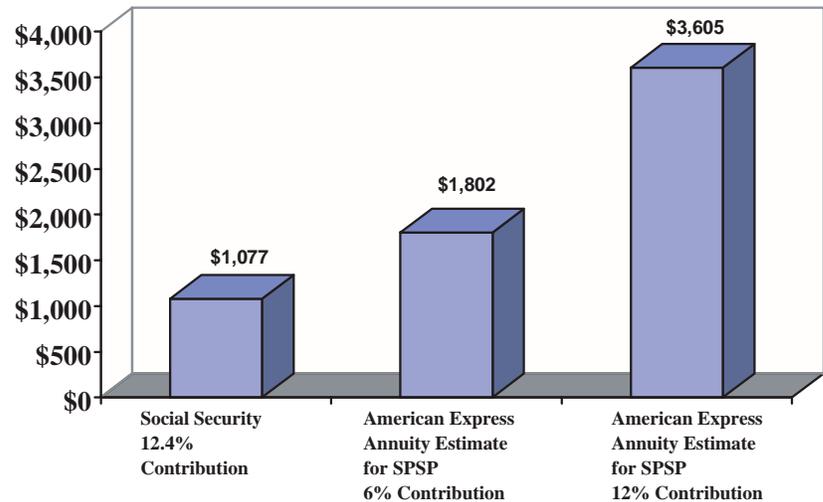
Year	Rate of Return (%)
1981	11.50
1982	15.50
1983	11.55
1984	11.00
1985	11.05
1986	9.50
1987	8.51
1988	9.01
1989	8.81
1990	7.82
1991	7.92
1992	6.92
1993	6.27
1994	4.92
1995	6.67
1996	4.67
1997	5.23
<b>Average</b>	<b>8.64</b>

Source: American United Life.

Employees also have the option of making additional contributions to their accounts, provided that the total of all contributions they make or that are made on their behalf do not exceed 25 percent of their adjusted gross pay or \$8,000 per year.<sup>44</sup>

Plan participants are allowed to withdraw the assets in their accounts throughout their lives in the event of an “unforeseeable emergency,” such as severe illness or severe loss of property (for example, if the account holder’s house burns down). Any other withdrawals prior to age 59.5 are subject to a penalty tax. Plan participants who retire may use the assets in their accounts for a variety of benefit payments. Retirees can purchase annuities solely for their own lifetimes or annuities that also provide pay-

**Figure 2  
Monthly Retirement Benefits of a Worker Making \$30,000, Who Works for 35 Years, Assuming a 7 Percent Real Rate of Return on Investments**



Source: Author’s calculation based on information provided by San Diego SPSP administrator.

ments to a spouse/beneficiary. A retiree can also elect to receive a lump-sum payment for the entire amount of the assets.<sup>45</sup>

In addition to retirement benefits, the Galveston Alternative Plan provides significant survivor benefits through a life insurance policy. The beneficiary of a plan participant under age 70 would receive a lump-sum payment of 300 percent of annual earnings, with a minimum benefit of \$50,000 and a maximum benefit of \$150,000. The beneficiary of a plan participant age 75 or older would receive a lump-sum payment of 130 percent of annual earnings, with a minimum benefit of \$33,330 and a maximum benefit of \$100,000.<sup>46</sup> In addition to this lump-sum payment, the retirement account becomes part of the individual’s estate and is transferable to heirs.

Employees are also protected through disability insurance. Individuals who qualify receive 60 percent of base pay up to a maximum benefit of \$5,000 per month, with a minimum monthly benefit of \$100. The disabled member is eligible to receive continued annuity deposits after payroll ceases until the employee resumes work or reaches age 65.<sup>47</sup>

The differences between Social Security retirement benefits and the benefits that will be generated by the assets in an individual’s account in the Galveston Alternative Plan are considerable. For example, a Galveston County employee with a constant annual salary of

**San Diego’s SPSP provides participants with more freedom and control over their retirement savings and allows individuals to enjoy market rates of return.**

**A Galveston County employee with a constant annual salary of \$30,000 would retire with an account worth more than \$320,000 after 40 years of work.**

\$30,000 would retire with an account worth more than \$320,000 after 40 years of work, assuming the fixed assets generate a real rate of return of 4.5 percent.

According to American United Life, the average annuity factor used for the plan has been 7.795, which means that for every \$1,000 a plan participant has accrued in his account, he would receive approximately \$7.80 per month. At age 65, a plan participant who has accrued assets of \$320,000 would receive a monthly payment of \$2,494. The Social Security Administration believes that this annuity factor is too high and requested that Galveston use an annuity factor of 6.487 when providing values for a GAO report on the program. Under the lower assumptions, the individual described above would receive a monthly payment of \$2,076.<sup>48</sup> Based on a still more conservative annuity estimate, the monthly payment would be about \$1,259.<sup>49</sup>

In contrast, if the same employee were required to participate in Social Security, he would be eligible for a monthly payment from Social Security of just \$1,077.<sup>50</sup>

It is worth noting how much better off Galveston County plan participants would have been without the provision mandating investment in assets with a fixed rate of return. The average annual S&P rate of return over the past 15 years was more than 14 percent.<sup>51</sup> Ray Holbrook, who helped set up the program in Galveston County, described the trade-off Galveston County made when it structured the program with a fixed rate of return:

A calculated decision was made not to invest in the stock market, even though retirement income would have been much more if that had been done, probably twice as much. Nevertheless retirement income for employees with 20 to 40 years of service is calculated to be 2 to 5 times the retirement income of Social Security. . . . In my own case after 14 years in the Alternate Plan and 27 years in Social Security, my monthly payments for retirement are about the same from both programs.<sup>52</sup>

**Massachusetts Teachers' Retirement System**

The Massachusetts Teachers' Retirement System (MTRS) was established in 1914 and

today covers nearly 110,000 public school teachers and administrators. The history of MTRS is particularly pertinent to the current debate about Social Security's future in that MTRS faced similar pay-as-you-go financing problems just a decade ago.<sup>53</sup> In 1976, a study conducted in Massachusetts found:

Under the present pay-as-you-go arrangement, the future costs of Massachusetts pension benefits are scheduled to increase dramatically from 12.1 percent of state-local employee payrolls in fiscal year 1978 to 31.9 percent in fiscal 1993.<sup>54</sup>

In 1987, MTRS began the transition to a funded system by establishing a 40-year funding schedule that would eliminate pension liabilities.<sup>55</sup> The following changes were implemented: MTRS "adopted and funded actuarially sound funding schedules, repealed regressive 'legal list' restrictions on the investment of system assets, repealed an arbitrary cap on system benefits, and monitored the system for abuse." As of January 1, 1998, the system was 77.7 percent funded.<sup>56</sup>

MTRS is a compromise between a defined-benefit and a defined-contribution plan. Although an MTRS participant receives a defined retirement benefit, the 9 percent of salary each teacher hired after July 1, 1996, contributes to an annuity savings account that is maintained on that teacher's behalf. The account accumulates interest at a rate established by the Public Employee Retirement Administration Commission.<sup>57</sup> The MTRS member is allowed to get a refund from the system if he leaves employment before age 55 and chooses the refund option; the assets in the account can also be passed on to a beneficiary if the MTRS member dies.<sup>58</sup>

Teachers become eligible to receive a retirement allowance when they have worked for 20 years or reach age 55 and have a minimum of 10 years of service.<sup>59</sup> Benefits are determined by a formula based on the retiree's age and length of service and the average of the highest three consecutive years' salary. Retirees can select one of three payment programs: a monthly benefit with no survivor provision, a slightly reduced monthly benefit with a one-time lump-sum payment to beneficiaries, and a monthly benefit reduced by 20-30 percent with a monthly benefit paid to a survivor.<sup>60</sup>

For example, a 62-year-old teacher who has worked for 35 years and had a final average salary of \$38,000 is eligible for a retirement allowance of \$29,260 per year, which provides a monthly benefit of \$2,438.33. The teacher also has the option to provide a spouse with a survivor benefit. If the spouse is the same age, the teacher's annual income could be reduced to \$23,408, which would provide a monthly benefit of \$1,950.66. The survivor would then receive a benefit of two-thirds that amount, which is an annual benefit of \$15,449.28 or a monthly benefit of \$1,287.44.<sup>61</sup>

Under Social Security, such a teacher would be eligible for a monthly benefit of approximately \$992 at age 62. That is just 41 percent of the benefit that the teacher under MTRS would receive as an individual. However, even if the teacher has a spouse and elects to provide a survivor benefit, MTRS still provides a far greater benefit than does Social Security. Under Social Security, the same teacher and a nonworking spouse would receive \$1,488—more than \$450 less than under MTRS. Social Security's survivor benefit payments are almost \$300 less than under MTRS.<sup>62</sup> Moreover, this quantitative analysis does not take into account the additional benefits of increased flexibility over retirement age.

The actuary for the Massachusetts Public Employee Retirement Administration also studied the differences between the benefits provided by Social Security and MTRS and concluded that Social Security's benefit is 43–75 percent less than the MTRS retirement benefit, depending on an individual's salary.<sup>63</sup>

In addition to retirement benefits, the MTRS provides survivor and disability insurance. When entering the MTRS program, each participant designates a beneficiary and benefit payment option. That can be either a lump-sum payment or "member-survivor" payment, which provides a monthly allowance to the beneficiary. If the lump-sum payment option is selected, the designated beneficiary receives the total balance of the member's account. If the member-survivor option is selected, the designated beneficiary (who must be a spouse, parent, sibling, child, or former spouse) receives a monthly payment equal to two-thirds of the amount that the member would have received under a joint and survivor allowance. If the member is younger than age 55 at the time of death, the benefits are still calculated for age 55.<sup>64</sup>

MTRS also provides disability benefits. According to the executive director, "For 1997, the average MTRS job related disability benefit was \$32,000; the average non-job related disability benefit was \$14,000 annually."<sup>65</sup>

MTRS can provide higher benefits than Social Security because, in addition to contributions from workers and employers, MTRS has assets that earn interest and thereby generate additional revenue. Since MTRS announced its 40-year funding schedule, its investments have exceeded the necessary 8.5 percent rate of return that was assumed. In 1997, management of MTRS assets was switched from the Massachusetts State Teachers' and Employees' Retirement Systems Trust (MASTERS) to the Pension Reserves Investment Trust (PRIT) fund, which also serves other Massachusetts retirement systems. The total value of the assets in the PRIT fund is more than \$24 billion dollars.<sup>66</sup> More than 60 percent of resources are invested in equities.<sup>67</sup>

Although the efforts of MTRS to fund its pension liabilities have been successful, the investment practices employed by and on behalf of MTRS reveal some of the more political uses of state-managed pension assets. The Massachusetts investment boards have had a policy of "in-state" investment initiatives. According to the final report of MASTERS, "beginning in 1992, with the advice of a blue-ribbon panel of local private sector investment and business professionals, MASTERS developed an in-state investment program, designed to generate market returns while benefiting the general economic climate of Massachusetts."<sup>68</sup> Those initiatives included a "purchase of mortgage-backed securities . . . directly supporting the Massachusetts residential mortgage market" and underwriting a multifamily low-income housing rehabilitation project in the South End of Boston because "the Massachusetts Housing Finance Authority had a project that needed financing."<sup>69</sup>

## Louisiana

In Louisiana, most government employees participate in state and local retirement plans in lieu of Social Security. In general, those plans are typical defined-benefit plans: a set percentage of payroll is contributed to the program and participants receive a fixed benefit at retirement.

**Social Security's benefit is 43–75 percent less than the MTRS retirement benefit, depending on an individual's salary.**

However, Louisiana's numerous plans demonstrate how these systems are structured specifically to meet the needs of different groups of employees.

For example, Table 4, which lists various Louisiana retirement plans, shows that the State Police Retirement System requires one of the largest contribution rates, but it allows members to retire at any age after 20 years of service. That provision recognizes that employees in high-stress jobs have different needs—such as the need for additional flexibility in determining retirement age—than the average public employee.

Robert Scully, the executive director of the National Association of Police Organizations, testified before the House Ways and Means

Committee on the unique needs of public safety officers and on how state and local retirement systems meet those needs more effectively than Social Security:

Let me describe the dilemma faced by public safety officers when Social Security's very limited disability, death and early retirement benefits are factored in, compared with current pension systems. Simply stated, the Social Security system was not designed for police officers and firefighters. . . . state and local governments have developed pension systems which acknowledge that police and firefighter jobs are very different than normal careers, with a set of dangers and stresses not faced by most other professionals. . . . Social Security death benefits are much lower than current retirement death benefits, which often pay anywhere from 50 percent to 75 percent of an officer's salary.<sup>70</sup>

The Louisiana Firefighters' Retirement System is another example of a program that has been structured to meet the specific needs of its members. As in a typical defined-benefit program, retirement benefits are determined by a typical set formula: years of service x the participant's final average salary x 3.33 percent. The program requires a total contribution rate of 17 percent of payroll.<sup>71</sup>

An important benefit of the system for workers in such a stressful and dangerous job is that members have a great deal of flexibility regarding retirement age. A member can retire, regardless of age, after 25 years of service. With just 12 years of service, a member can retire at age 55.

The disability benefits provided by the Louisiana Firefighters' Retirement System are also more generous than those paid by Social Security. From the first day of work, a member of the firefighters' retirement system is eligible for full disability benefits for an on-the-job injury. The benefit consists of 60 percent of the final average salary. To qualify for disability payments if the disability does not occur on the job, a worker must have five years of service. He would then be eligible to receive the greater of 75 percent of the retirement salary he would be

**Table 4**  
**Comparison of Various Louisiana Non-FICA Retirement Systems and Social Security**

Retirement System	Maximum Retirement Benefit*	Conditions for Retirement Eligibility	Contribution Rate (%)	Number of Active Participants
Social Security	\$ 805.00	Age 65	12.40	
School Employees' Retirement System	\$1,393.33	Any age with 30 years' service	12.35	15,000
State Employees' Retirement System	\$1,275.00	Any age with 30 years' service	11.95	70,000
State Police Retirement System	\$1,500.00	Any age with 20 years' service	20.50	1,000
Teachers' Retirement System of Louisiana	\$1,250.00	Age 55 with 30 years' service	24.50	85,169
Clerks of Court Retirement and Relief Fund	\$1,500.00	Age 55 with 30 years' service	18.25	2,114
District Attorneys' Retirement System	\$1,666.67	Any age with 25 years' service	7.00	586
Firefighters' Retirement System	\$1,665.00	Any age with 25 years' service	17.00	2,500
Louisiana Assessors' Retirement Fund	\$1,500.00	Age 50 with 30 years' service	12.75	700
Municipal Police Employees' Retirement System	\$1,665.00	Any age with 25 years' service	16.50	4,400
Parochial Employees' Retirement System	\$1,500.00	Any age with 30 years' service	17.25	13,000
Sheriffs' Pension and Relief Fund	\$1,625.00	Age 55 with 25 years' service	13.70	10,000

\*Based on \$20,000 annual salary and 30 years' service.

Source: Materials distributed by the Louisiana Association of Public Employees' Retirement Systems and Louisiana Sheriffs' Association, "Impact of Mandatory Social Security Coverage on Louisiana's Public Employees and Employers," December 16, 1998.

entitled to if he were to retire on that day or 25 percent of his final average salary.<sup>72</sup>

For example, a young firefighter making \$20,000 a year or \$1,667 per month would be eligible for a monthly disability payment of \$1,000 from the first day on the job. Under Social Security, the same firefighter would have had to work for at least six quarters to be eligible for disability protection.<sup>73</sup> Under Social Security, a worker's disability benefit is based on average indexed monthly earnings (AIME) and is computed as if that worker had reached full retirement age on the day he became disabled. The average monthly disability payment is only \$704.<sup>74</sup> However, for a young worker who has not contributed to Social Security for many years and so has a low AIME, disability payments would be far less.

The administrators of the Louisiana retirement programs view the additional benefits and flexibility provided by their systems as a way of attracting employees:

For many years, one of the primary benefits attracting police officers, firefighters, and others to City-Parish employment has been our retirement program which offers benefits much greater than those offered by the Social Security program.<sup>75</sup>

The efforts of these state and local retirement programs to tailor plans to the needs of employees contrast with the one-size-fits-all nature of the federal Social Security program.

Louisiana's pension assets are invested under state laws, which set a minimum and a maximum percentage of assets that can be invested in equities.<sup>76</sup> Typically, the pension board managers contract with private investment managers to handle the investment allocations.<sup>77</sup> Although it appears that Louisiana has largely avoided the problems associated with economically targeted investing and social investing, there has been some controversy about the selection of the fund's money managers. In 1995, a dispute between the mayor and the board of the New Orleans city workers' retirement fund resulted in an investigation by the city's Office of Municipal Investigation. The report issued by that office suggested that the selection of a managing company had been influenced by cronyism.<sup>78</sup>

## Public Employees Retirement System of Ohio

The Public Employees Retirement System of Ohio (PERS) was set up in 1935 and today provides retirement, disability, and survivor benefits to public employees who are not covered by another state or local retirement program.<sup>79</sup> There are more than 400,000 active and inactive members in PERS and more than 100,000 retirees or surviving beneficiaries who receive monthly payments from the program.<sup>80</sup> PERS has more than \$45 billion in assets, which generate substantial revenue for the program.<sup>81</sup> In fact, in 1997 the income generated by investments accounted for 73 percent of total revenue, whereas member and employer contributions accounted for just 27 percent.<sup>82</sup> The additional revenue allows PERS to offer more generous benefits to its members than would a pay-as-you-go system such as Social Security.

The components of the PERS plan are varied slightly to meet the needs of different occupations. For example, the contribution rates for law enforcement officers are higher, but they are given greater freedom in electing retirement age.<sup>83</sup> State employers pay 13.31 percent of reportable payroll to PERS; local employers, 13.55 percent; and law enforcement employers, 16.7 percent. Most public employees contribute 8.5 percent of salary to PERS; law enforcement officers pay 9.0 percent.<sup>84</sup>

Employees' contributions are credited to savings accounts held on their behalf. Individuals are kept informed of the accumulations in their accounts by a statement that is sent out during the first quarter of each year. An employee who leaves the job may reclaim the money in the account (which is considered a tax event), roll the money into an IRA, or, if the employee has served at least five years, receive a benefit at retirement based on contributions.

Workers are also given the opportunity to put away additional money in a savings program. The money contributed earns interest at a rate set by the PERS Retirement Board. Federal tax law limits deposits to 25 percent of a member's annual income or \$30,000. This money and the interest earned may be refunded or used for an additional annuity at retirement.

**An important benefit of the system for workers in such a stressful and dangerous job is that members have a great deal of flexibility regarding retirement age.**

**State and local retirement plans provide plan participants with more benefits and greater flexibility with regard to retirement age and plan payout than does Social Security.**

PERS provides disability benefits to workers who have at least five years of service credit and have a permanently disabling condition. The benefit is based on final average salary (FAS) and years of service with PERS, but cannot be less than 45 percent or exceed 60 percent of FAS.<sup>85</sup> PERS also provides workers with a “surviving spouse” benefit. The surviving spouse of a worker with less than 10 years of service receives the higher of \$96 or 25 percent of FAS per month; the surviving spouse of a worker with more than 10 years of service receives the higher of \$106 or 25 percent of FAS per month. If the worker was eligible to retire at the time of death, the spouse would be eligible for a payment equal to what would have been received if the worker had selected the retirement option with the highest survivor benefit. Dependent children and parents are also eligible for benefits.<sup>86</sup>

Participants in PERS have a great deal of flexibility about the timing of retirement and the payment options. Workers who are age 60 and have five years of Ohio service are eligible for a retirement benefit. Workers who have served for longer periods may retire earlier. A participant who has worked for 25 years may retire at age 55. A worker with 30 years’ service may retire with full benefits at any age.

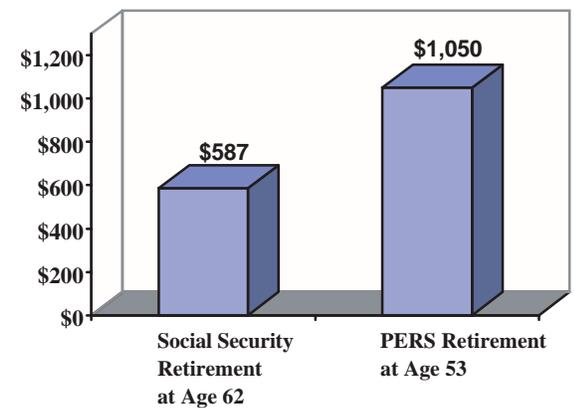
A worker’s benefits are determined by a formula that takes into account the worker’s length of service, final average salary (the average of the worker’s three highest years of salary), age, and plan payment selection.<sup>87</sup> Payment plan options include a single life annuity or a selection of lesser annuities that continue during the lifetime of a spouse or are paid to a designated beneficiary. The plans are of equal actuarial value, but monthly payments differ because of the cumulative life expectancies covered. An annual cost-of-living adjustment is also provided to benefit recipients.<sup>88</sup>

The single life annuity is calculated by multiplying 2.1 percent of a worker’s final average salary by the first 30 years of service and 2.5 percent of final average salary for each year (or portion thereof) of service over 30 years. For workers who retire with less than 30 years of service or before age 65, benefits are reduced by a set percentage.<sup>89</sup>

For example, a worker who is 53 years old, with 30 years of service, and a final average salary of \$20,000 would receive an annual ben-

efit of \$12,600 or \$1,050 monthly.<sup>90</sup> Under Social Security, that individual would be unable to retire until age 62. At that time, in return for the 30 years of service, with a salary of \$20,000, the worker would be eligible for a monthly payment of roughly \$587. As shown in Figure 3, a PERS participant retiring at 53 receives almost twice the retirement benefit received by a worker participating in Social Security who retires at age 62.

**Figure 3**  
Comparison of Monthly Retirement Benefits under Ohio PERS and Social Security for Workers Making \$20,000 after 30 Years of Service



Source: Author’s calculation based on information in Ohio PERS “Member Handbook.”

Although the PERS program shows the financial benefits of prefunding, it also provides warnings for those who believe the federal government should have the power to invest Social Security revenues. PERS funds are invested in accordance with Ohio state law, which states:

In exercising its fiduciary responsibility with respect to the investment of the funds, it shall be the intent of the board to give consideration to investments that enhance the general welfare of the state and its citizens where the investments offer quality, return, and safety comparable to other investments currently available to the board. In fulfilling this intent, equal consideration shall also be given to investments otherwise qualifying under this section that involve minority owned and controlled firms and firms owned and controlled by women, either alone or in joint venture with other firms.<sup>91</sup>

In addition to working to serve participants in the retirement program, investment managers are also directed to consider how to benefit the state of Ohio. Such efforts to target investments in-state and toward specific groups have been shown to lower returns and to create potential conflicts of interest.<sup>92</sup>

## Conclusions

Overwhelmingly, state and local retirement plans have been found to provide plan participants with more benefits and greater flexibility with regard to retirement age and plan payout than does Social Security. Those state and local plans can provide superior benefits because they predominately prefund future benefits, either by saving and investing the program's income or by allowing the participants to save and invest their contributions in accounts that will provide for their own future benefits. Those programs provide important lessons for policymakers attempting to reform Social Security. Some of those lessons are summarized below.

### Defined-Contribution Plans Are Superior to Defined-Benefit Plans

Although defined-benefit plans affirm the benefits of prefunding and the power of investment, they pose potential dangers to their participants and ultimately to the economy at large. Since participants in defined-benefit plans do not own their retirement savings, they face the possibility that plan sponsors will change benefit formulas or will be unable to pay benefits in the future. Moreover, investment choices in defined-benefit plans are often influenced by political pressure. This introduces additional danger for the plan participants, since such investments are often riskier than are those taken on by a private investor. For the economy and society, the ability of states and localities to invest in private companies creates the potential for cronyism and manipulation of the market.

Defined-contribution plans avoid these problems because participants in such plans own their retirement savings. They do not face the risk that their plans will ultimately be unable to meet obligations because their benefits come directly from their accounts. That also allows participants to take full advantage of the market and to assume the degree of risk with which they feel most comfortable.

San Diego's SPSP plan provides one example of how a mandatory defined-contribution program can be set up and administered. San Diego's plan is structured to help educate participants about investment, but it also provides a default fund so that any individual who chooses not to participate actively in the investment strategy still receives a market rate of return. Galveston County confirms those findings and highlights how participation in the market does not require participants to shoulder a great deal of risk.

The superiority of defined-contribution plans is increasingly recognized. The growth and popularity of 401(k) plans and the IRA industry are testimony to the public's support for such systems. Throughout the country, many states and localities that offer defined-benefit retirement plans in addition to Social Security are moving to change their systems to defined-contribution structures.<sup>93</sup>

Policymakers attempting to reform Social Security should adopt the structure of a defined-contribution plan by giving individuals the option to redirect payroll taxes to an account that they would own and invest.

### Retirement Systems Should Recognize the Different Needs of Individuals

The state and local retirement plans are also superior in that they recognize that individuals have different needs in retirement and attempt to provide flexibility to their participants in electing retirement age, plan payment method, and survivor coverage.

The differences between the state and local retirement plans and Social Security are the typical differences between private companies and companies protected by a monopoly. Because states and localities view retirement plans as a means of attracting and keeping valuable employees, they structure their plans to meet the needs of the plan participants.

A particularly compelling example can be found in Louisiana. Representatives of Louisiana's retirement programs emphasize how their benefit plans are vital for attracting employees, particularly since they are often unable to pay as much as private-sector companies. Louisiana's various programs demonstrate their recognition that people have different definitions of "retirement security" and different needs.

**The superiority of defined-contribution plans is increasingly recognized. The growth and popularity of 401(k) plans and the IRA industry are testimony to the public's support for such systems.**

Of course, a system of PRAs can be structured so that decisions about retirement can be left entirely to the person who knows best how to meet the individual's definition of "retirement security"—the individual.

### **State and Local Workers Should Not Be Forced into Social Security**

Several proposals for reforming Social Security recommend mandating that all new state and local employees be forced to participate in Social Security.<sup>94</sup> The resulting influx of revenue into Social Security would reduce the federal government's 75-year unfunded liability by just 10 percent, according to a GAO study.<sup>95</sup> Such a small, temporary improvement in Social Security's finances does not justify jeopardizing the retirements of five million state and local employees.

Instead, policymakers should learn from the successes and failures of the state and local retirement plans and reform the federal program to incorporate the best aspects of those programs, by moving toward a fully funded system of individually owned, privately invested retirement accounts.

### **Notes**

<sup>1</sup>Social Security Administration, Office of the Inspector General "Social Security Coverage of State and Local Government Employees," December 13, 1996, p. 3.

<sup>2</sup>Ibid.

<sup>3</sup>Cynthia M. Fagnoni, U.S. General Accounting Office, in testimony before the Subcommittee on Social Security of the House Committee on Ways and Means, May 21, 1998, p. 2.

<sup>4</sup>Ibid.

<sup>5</sup>U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments, 1994* (Washington: U.S. Government Printing Office, 1996), p. 110.

<sup>6</sup>Ibid., p. 113.

<sup>7</sup>Ibid., pp. 111–113.

<sup>8</sup>Ibid., p. 23.

<sup>9</sup>William E. Even and David A. MacPherson, *Freed from FICA: How Seven States and Localities Exempt a Million Employees from Social Security and Provide Higher Pension Benefits to Retirees* (New York: Third Millennium, 1997).

<sup>10</sup>The seven systems studied were the California State Teachers Retirement System, the Los Angeles City Employees' Retirement System, the Maine State Retirement System, the Ohio Public Employees Retirement System, the Ohio State Teachers Retirement System, the Public Employees' Retirement Association of Colorado, and the Public Employee Retirement System of Nevada General Employees Plan.

<sup>11</sup>Ibid., p. 2.

<sup>12</sup>U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments, 1994*.

<sup>13</sup>Fagnoni, p. 1.

<sup>14</sup>Ibid.

<sup>15</sup>Even and MacPherson, p. 2.

<sup>16</sup>Jennifer D. Harris, *From Broad to Specific: The Evolution of Public Pension Investment Restrictions* (Washington: Public Retirement Institute, July 1998), p. 2.

<sup>17</sup>Ibid., p. 5.

<sup>18</sup>James Packard Love, *Economically Targeted Investing: A Reference for Public Pension Funds* (Sacramento: Institute for Fiduciary Education, 1989).

<sup>19</sup>Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, in testimony before the Senate Committee on the Budget, January 28, 1999, p. 2.

<sup>20</sup>Joint Economic Committee House Staff Report, "The Economics of ETIs: Sacrificing Returns for Political Goals," September 1995, p. 1.

<sup>21</sup>Ibid.

<sup>22</sup>Joint Economic Committee Briefing, "Economically Targeted Investments (ETIs)," June 15, 1995, p. 3.

<sup>23</sup>Joint Economic Committee House Staff Report, p. 4.

<sup>24</sup>Harris, p. 2.

<sup>25</sup>Memo from Stephen C. Goss, Depute Chief Actuary for the Social Security Administration, to Harry C. Ballantyne, Chief Actuary for the Social Security Administration, dated February 12, 1999 (on file at the Cato Institute).

<sup>26</sup>For more information on this issue, see Michael Tanner, "The Perils of Government Investing," Cato Institute Briefing Paper no. 43, December 1, 1998.

<sup>27</sup>January 8, 1999, memo from Bruce A. Herring, San Diego Deputy City Manager, to the Mayor and City Council members, p. 2 (on file at the Cato Institute).

<sup>28</sup>In addition to the SPSP program, San Diego provides its employees with a defined-benefit program, the San Diego City Employees' Retirement System. Employees pay between 7 and 13 percent of their salary, of which the city contributes 5 or 6 percent depending on job classification; benefits are determined by using a formula that takes into account age, length of service, and final average salary, and adjustments are made to benefits to account for changes in the cost of living. The program also provides survivor and

disability insurance. More information is available in the San Diego City Employees' Retirement Handbook, May 1998.

<sup>29</sup>The additional contribution was reduced because of the requirement that public employers must contribute to Medicare.

<sup>30</sup>Information provided by Valerie VanDeweghe, benefits administrator for the City of San Diego.

<sup>31</sup>A package of information is provided by the City of San Diego's Risk Management Department Employee Benefits Division.

<sup>32</sup>"Plan Highlights," pamphlet provided by the city of San Diego (on file at the Cato Institute).

<sup>33</sup>Critics of the program would note the "moral hazard" created by allowing individuals access to their retirement funds while working. The benefits of allowing individuals to choose how to use their resources are unquantifiable: they can invest in their children's education or provide for a home. This provision, however, does introduce the potential problem that individuals will consume their retirement savings during their working lives. Clearly, if Social Security were reformed to become a defined-contribution program, legislators would have the option of eliminating this provision.

<sup>34</sup>In all calculations, salaries are held constant.

<sup>35</sup>Melissa Hieger and William Shipman, "Common Objections to a Market-Based Social Security System: A Response," Cato Institute Social Security Paper no. 10, July 22, 1997, p. 7.

<sup>36</sup>Information provided by American Express Financial Advisors to the City of San Diego plan administrator, February 18, 1999. Since annuities are affected by changes in life expectancy, future annuity payments could be reduced due to increased life expectancies.

<sup>37</sup>The annuity was calculated by using the 17.3-year life expectancy provided for a 65-year-old in the year 2035, given on p. 60 of the 1998 Old-Age and Survivors Insurance and Disability Insurance (OASDI) Trust Fund Report. Calculations also assume an annuitization charge of 20 percent.

<sup>38</sup>The three counties are Galveston, Matagorda, and Brazoria.

<sup>39</sup>Ray Holbrook, "The Galveston County Alternative Social Security Plan," September 1998 (on file at the Cato Institute).

<sup>40</sup>There are approximately 3,000 employees of the three Texas counties covered by alternative plans. General Accounting Office, "Social Security Reform: Experience of the Alternate Plans in Texas," February 26, 1999, p. 7.

<sup>41</sup>According to the GAO study, "Social Security Reform: Experience of the Alternate Plans in Texas," p. 8, in 1998, the premium for life and disability was 4.178. Therefore, 3.607 percent of payroll was contributed by the city on behalf of the employee, making the cumulative contribution to each worker's account 9.737 percent of payroll.

<sup>42</sup>Conversation with Don Kebodeaux, First Financial Capital Corporation, October 19, 1998.

<sup>43</sup>Information provided by American United Life, the Galveston Alternative Plan annuity provider, dated January 21, 1999.

<sup>44</sup>"A Summary of the Alternate Plan for Galveston County Employees," First Financial Benefits, Inc., 1996, p. 17. This publication lists the cap at \$7,500; however, according to the plan administrator the maximum contribution level was raised recently to \$8,000.

<sup>45</sup>The Galveston plan is a deferred-compensation plan for government employees, considered under Section 457 of the Internal Revenue Code of 1986. There is a tax penalty for withdrawal prior to age 59.5. After that, withdrawals are considered income and subjected to standard income tax. "A Summary of the Alternate Plan for Galveston County Employees," p. 11. Options for plan payout are covered on pages 22-23.

<sup>46</sup>"A Summary of the Alternate Plan for Galveston County Employees," p. 3.

<sup>47</sup>*Ibid.*, p. 4.

<sup>48</sup>Information provided by American United Life, the Alternative Plan annuity provider, dated January 21, 1999 (on file at the Cato Institute).

<sup>49</sup>See note 37.

<sup>50</sup>The GAO study, "Social Security Reform: Experience of the Alternate Plans in Texas," points out that annuities do not necessarily provide "inflation protection" through cost-of-living adjustments as does Social Security. During the 1990s, inflation has been very low; however, if there were to be a return to the high inflation of the 1970s, this could have an effect. But individuals in the Galveston plan are not required to annuitize their assets and therefore could avoid this problem by selecting another payment option.

<sup>51</sup>Calculation based on the S&P December monthly closing prices from 1982 to 1997. Yale Hirsch, *1999 Stock Trader's Almanac* (Old Tappan, N.J.: The Hirsch Organization, 1998), pp. 142-143.

<sup>52</sup>Holbrook.

<sup>53</sup>Thomas Lussier, Executive Director of the Massachusetts Teachers' Retirement Board, Testimony before the House Ways and Means Committee on May 21, 1998, p. 1.

<sup>54</sup>As quoted on page 2 of Thomas Lussier's testimony. Report of the Funding Advisory Committee and the Retirement Law Commission to the Governor and General Court of Massachusetts, October 1976.

<sup>55</sup>"Promises to Keep," Final Report of the Massachusetts State Teachers' and Employees' Retirement System Trust, December 31, 1996, and the Annual Report of the Pension Reserves Investment Trust Fund, June 30, 1997, p. 9.

<sup>56</sup>Information provided by Thomas Lussier, Executive Director of the Massachusetts Teachers' Retirement Board.

- <sup>57</sup>By statute, the interest rate must be fixed at an average passbook savings rate. Massachusetts Teachers' Retirement Board, "As a New Member," May 1997, pp. 3-4.
- <sup>58</sup>*Ibid.*, p. 17.
- <sup>59</sup>*Ibid.*, p. 7.
- <sup>60</sup>*Ibid.*, p. 28.
- <sup>61</sup>*Ibid.*, pp. 30-32.
- <sup>62</sup>MTRS also provides an annual cost-of-living adjustment equal to the consumer price index or 3 percent, whichever is lower, payable on the first \$12,000 of a member's benefit. Lussier, p. 4.
- <sup>63</sup>Lussier, p. 3.
- <sup>64</sup>Massachusetts Teachers' Retirement Board, "As the Survivor of an Active Member," September 1995, pp. 2-4.
- <sup>65</sup>Lussier, p. 3-4.
- <sup>66</sup>"Preserving Your Trust," Annual Report of the Pension Reserves Investment Trust Fund, June 30, 1998, p. 21.
- <sup>67</sup>PRIT, p. 17.
- <sup>68</sup>"Promises to Keep," p. 11.
- <sup>69</sup>*Ibid.*, pp. 11-12.
- <sup>70</sup>Robert T. Scully of the National Association of Police Organizations in testimony before the Subcommittee of Social Security of the House Committee on Ways and Means on May 21, 1998, p. 3.
- <sup>71</sup>Materials provided by the Firefighters' Retirement Systems, which were distributed by the Louisiana Association of Public Employees' Retirement Systems and Louisiana Sheriffs' Association, during their briefing, "Impact of Mandatory Social Security Coverage on Louisiana's Public Employees and Employers," December 16, 1998.
- <sup>72</sup>Louisiana revised statute 11:2258, "Disability Retirement."
- <sup>73</sup>U.S. House of Representatives, Committee on Ways and Means, *1998 Green Book* (Washington: Government Printing Office, 1998), p. 12.
- <sup>74</sup>*Ibid.*, p. 17.
- <sup>75</sup>Otha L. Schofield, Director of Finance, City-Parish Government, and Chairman of the Board, City-Parish Employees Retirement System, memo to the members of the Louisiana congressional delegation, December 16, 1998, p. 2 (on file at the Cato Institute).
- <sup>76</sup>Louisiana revised statute 11:267, "Indexing; equity limitations."
- <sup>77</sup>Information received from Trey Hodgkins III of the Louisiana Sheriffs' Association.
- <sup>78</sup>"All five members of the city's Municipal Employees Retirement Board, including the city's finance director, accepted gifts in 1994 from companies managing or seeking a chance to manage a piece of the city's \$220 million pension fund, the report said." Christopher Cooper, "Pension Board Gifts Criticized," *Times-Picayune*, April 22, 1995, A1.
- <sup>79</sup>Public Employees Retirement Systems of Ohio, "Member Handbook," April 1998, p.1.
- <sup>80</sup>*Ibid.*
- <sup>81</sup>Public Employees Retirement System of Ohio Comprehensive Annual Financial Report, December 31, 1997, p. 16.
- <sup>82</sup>*Ibid.*, p. 11.
- <sup>83</sup>PERS "Member Handbook," p. 8, 39.
- <sup>84</sup>*Ibid.*, p. 8.
- <sup>85</sup>*Ibid.*, p. 24.
- <sup>86</sup>*Ibid.*, p. 29.
- <sup>87</sup>Under no circumstances can the benefit exceed 100 percent of final average salary.
- <sup>88</sup>*Ibid.*, p. 32.
- <sup>89</sup>*Ibid.*, p. 17.
- <sup>90</sup>*Ibid.*, p. 18.
- <sup>91</sup>Ohio Revised Code, Section 145.11B.
- <sup>92</sup>An example of such target investing occurred in 1992, when PERS, along with several other retirement systems in Ohio, became a limited partner in a venture capital fund with two separate funds, one focusing on minority- and women-owned businesses and the other on small businesses in Greater Cincinnati. See Steve Watkins, "Corporations Invest in Gradison Venture Fund," *Greater Cincinnati Business Record*, December 21, 1992, p. 1. In the early 1990s, PERS also invested in an AFL-CIO Housing Trust. See Ellen James Martin, "Social Investing's 1990s Spin," *Institutional Investor*, March 1, 1993.
- <sup>93</sup>For more information on this issue, see Peter Ferrara, "Pension Liberation: A Proactive Solution for the Nation's Public Pension Systems," American Legislative Exchange Council, August 1997; Joel Mowbray, "The Prospect of Liberty in Kansas Pension Reform," Kansas Public Policy Institute, December 21, 1998; and Girard Miller and Joseph J. Jankowski Jr., "Public-Sector Defined Contribution Plans: Lessons from Seven Governments," *Government Finance Review*, December 1998, pp. 29-33.
- <sup>94</sup>Proposals include S.2313, introduced by Senator Gregg and Senator Breaux; H.R.4256, introduced by Congressman Kolbe and Congressman Stenholm; S.1792, introduced by Senator Moynihan and Senator Kerrey; Option 1 of the 1994-1996 Advisory Council on Social Security, written by Robert Ball; and the proposal of Henry Aaron and Robert Reischauer of the Brookings Institution as described in *Countdown to Reform: The Great Social Security Debate* (New York: Century Foundation Press, 1998).
- <sup>95</sup>General Accounting Office, "Implications of Extending Mandatory Coverage to State and Local Employees," August 1998, p. 7.