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State and Local Retirement Plans: Innovation and Renovation

by David Rajnes, EBRI

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Special Report
and Issue Brief

- This *Issue Brief* examines the universe of state and local retirement plans. It describes how these plans have developed and continue to evolve in a number of areas, including plan features, regulatory framework, governance, and asset management. While these retirement programs differ in many respects from private-sector plans, the disparity in some areas has narrowed. This report also includes a discussion of trends and the underlying forces for change.

- Public-sector retirement programs provide an important source of pension coverage in the United States, and are a significant part of the total retirement market: Combined public-sector retirement assets (state, local, and federal governments) comprised 29 percent of the $11.2 trillion U.S. retirement market in 1998.

- State and local plans are dominant in the public-sector retirement market, holding $2.7 trillion in assets, compared with $696 billion held by federal plans (both military and civilian). More than 16 million individuals are employed by state and local jurisdictions in the United States.

- State and local retirement plans share certain common features because of the environment in which they operate. Legal statutes, governance, and tradition all play a role in defining what is sometimes referred to as a "public-sector culture." Despite common features, there is considerable diversity among public-sector retirement plans.

- To attract and retain a skilled work force, public-sector employers have increased their use of defined contribution (DC) plans to supplement defined benefit (DB) plans (or, to a lesser extent, replace or serve as an alternative to them) and improve cost-of-living adjustments. At the same time, a combined federal-state regulatory framework has encouraged certain plan design features, unavailable in the private sector, which include multiple tiers for successive generations of employees in a single plan and different strategies to increase portability.

- State and local retirement plans reflect an increasing role by the federal government in pension system design and operation, which has led to greater complexity in such areas as Social Security participation and deferred compensation arrangements. Complexity can be expected to increase with the recent passage of P.L. 107-16, the Economic Growth and Tax Relief Reconciliation Act of 2001.

- The latest full-year data included in this report are for 1999 and in some cases 2000. After this report went to press, the Federal Reserve issued significantly revised quarterly data for state, local, and federal retirement plan assets, which were not incorporated in this *Issue Brief.*

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Introduction

More than 16 million individuals are employed by state and local jurisdictions in the United States. The vast majority are covered under retirement programs sponsored by public-sector employers that include state, county, and municipal governments, as well as school districts and other special-purpose authorities. These retirement programs provide an important source of pension coverage in the United States, and are a significant part of the total retirement market: Combined public-sector retirement assets (state, local, and federal governments) comprised 29 percent of the $11.2 trillion retirement market in the United States in 1998.

State and local retirement plans share certain common features because of the environment in which they operate. Legal statutes, governance, and tradition all play a role in defining what is sometimes referred to as a "public-sector culture."[1] These similarities provide an opportunity to examine how retirement plans operate outside the federal regulatory and social insurance frameworks imposed on the private sector. They also permit a chance to evaluate regulatory provisions and recent arguments for reform through a comparative analysis of these plans with private-sector plans.

Similarities aside, the diversity found in benefit design, operations, and management style is notable. Systems range in size from small entities at the local level to large state operations, which include prominent institutional investors in U.S. financial markets. This diversity plays a role in benefits design, because local government employees may have career patterns that require different retirement plan benefits than other state (including education) employees.

Historically, changes in the economy and regulatory environment have motivated state and local government plan sponsors to adjust their retirement programs. Thus, the increasing use of defined contribution (DC) plans to supplement defined benefit (DB) plans (or, to a lesser extent, replace or serve as an alternative to them), improved cost-of-living adjustments (COLAs), and other modifications to benefits provision in the public sector should be considered efforts on the part of plan sponsors to attract and retain a skilled work force. At the same time, a combined federal-state regulatory framework has encouraged certain plan design features, unavailable in the private sector, which include multiple tiers for successive generations of employees in a single plan and different strategies to increase portability. It is clear that funding and political factors have also played a role in encouraging an orientation toward more individual retirement provisions (e.g., individual accounts), which has also been evident in the private sector.

Trends observed in state and local plans also reflect an increasing role by the federal government in retirement system design and operation, which has led to greater complexity in such areas as Social Security participation and deferred compensation arrangements. Complexity can be expected to increase with the recent passage of P.L. 107-16, the Economic Growth and Tax Relief Reconciliation Act of 2001 (see Appendix). Key areas of importance for state and local retirement systems include: contribution and benefit limits, rollovers of retirement plan and individual retirement account (IRA) distributions, purchase of service credit, and catch-up provisions. Changes in these areas will only increase the flexibility available to plan sponsors in benefit design. Moreover, future consideration of Social Security reform may affect state and local plans currently operating outside the federal system. It seems likely, in view of the guidelines given by President Bush to the new Social Security reform commission, that mandatory participation of new state and local employees in non-Social Security retirement systems will be considered.

[1] *Public retirement systems include not only state and local plans discussed here, but other civilian as well as military retirement systems operated at the federal level.*

This *Issue Brief* examines the universe of state and local retirement plans. It describes how these plans have developed and continue to evolve in a number of areas, including plan features, regulatory framework, governance, and asset management. While these retirement programs differ in many respects from private-sector plans, the disparity in some areas has narrowed. This report also includes a discussion of trends and the underlying forces for change.

History & Legal Perspective

The New York City police force is recognized as the first group of civilian employees at the state or local level to be covered by a public employee retirement system in the United States (1857).[2] By the end of the 19th century, employers in both public and private sectors were seeking ways to provide economic welfare for employees at the conclusion of their careers. Many of these early systems covered only teachers or workers in public safety occupations, such as firefighters and police officers—groups still covered in occupation-specific pension plans operated at the state and local levels.

Over the next 50 years, numerous retirement plans in state and local jurisdictions came into existence. The first state employee retirement system was established by Massachusetts in 1911 for general service employees. By 1930, 12 percent of the larger state-administered pension systems currently in existence had been established. Between 1931 and 1950, half of the largest state and local plans in the country were established (U.S. Congress, 1978). From 1941 to 1947, the remaining 22 states began to offer pension plans to their work force (EBRI, 1997; Munnell and Connelly, 1979). This period also saw the initiation of a national retirement income policy with passage of the Social Security Act of 1935. Public-sector employees were originally excluded from coverage, partly due to constitutional concerns about the federal government's right to tax state and local governments, and partly because many state and local employees were already covered under public retirement systems (Zorn, 1999).

The following decades witnessed a series of legal changes that brought many state and local pension plans into the Social Security system. In the 1950s, public-sector employers without a retirement plan were allowed to elect Social Security coverage by entering into "Sec. 218 Agreements" with the Social Security Administration.[3] Employers could identify groups of employees for possible addition to Social Security under this arrangement, with the result that employers might have none, some, or all of their employees participating in the federal program (Harris, 1998c). In practice, public-sector employers were thus able to opt into and out of Social Security even if their employees were covered by an in-state retirement system. Changes to the Social Security law in 1983, however, barred public-sector employers from leaving the Social Security system.[4] In 1991, Congress extended mandatory Social Security coverage to state and local government employees not covered by a public pension plan. At present, only new employees enrolling in existing public-sector retirement plans, which operate outside Social Security, may opt out.

Today, state and local governments hold the bulk of public-sector retirement assets. Of the $11.2 trillion in total retirement market assets in 1998, state and local government plans accounted for $2.7 trillion (or about 23 percent), and federal government plans (including both military and civilian employees) accounted for $686 billion (or about 6 percent). Combined public-sector assets accounted for almost 30 percent of all retirement plan assets in the United States (chart 1).

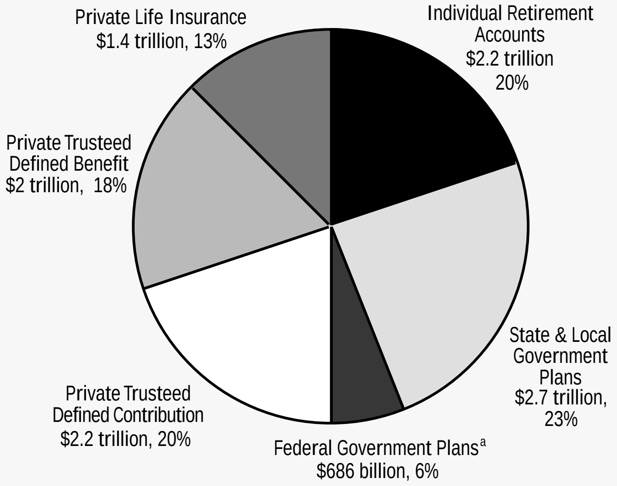
[2] *Military pension plans preceded those established for public employees. For example, pension plans were created for the navy and army in 1775 and 1776, respectively (Clark et al., 2001).*

[3] *Named after that section of the Social Security Act permitting voluntary participation.*

[4] *More specifically, the law stipulated that once Social Security coverage was extended to any group of employees, the employer could not remove them (Harris, 1998c).*

Chart 1

Sources of Assets for the Retirement Market, 1998 (Total: $11.2 trillion)



Source: *EBRI's Pension Investment Report*, Investment Company Institute, American Council of Life Insurance, Federal Deposit Insurance Corp., U.S. Census Bureau, Federal Reserve, Credit Union National Association, U.S. Department of Defense, U.S. Office of Personnel Management, and the Federal Thrift Investment Board.

[a]Military and civilian.

ERISA

Another aspect of public-sector retirement plans that has been influenced by the federal government is their regulatory framework. State and local retirement 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.[5] This distinction, however, has been modified in recent decades by heightened federal involvement in the regulatory environment—first with private-sector employment-based benefit plans, and then incrementally for state and local plans thereafter. 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 retirement plans from certain sections of ERISA "... 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 after ERISA and reported certain deficiencies in public plans in the areas of funding, reporting and disclosure, and fiduciary practices.[6]

Nearly three decades later, however, state and local government plans still enjoy a general exemption from many requirements of ERISA.[7] But while many ERISA provisions do not always apply to retirement plans of state and local governments,[8] those requirements may indirectly influence plan design and administration in areas ranging from investment and fiduciary standards to pension rights of surviving spouses.[9] Moreover, although public-sector plans are excluded from several sections of ERISA, these plans are required to comply with pre-ERISA requirements of the Internal Revenue Code (IRC).[10] These pre-ERISA requirements thus continued to shape the plan qualifica-

[5] *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).*

[6] *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. It intended to improve income security by bringing state and local plans under federal jurisdiction in order to remedy some of the deficiencies cited in the congressional study.*

[7] *ERISA includes a group of provisions under the Internal Revenue Code (IRC), all of which apply to private plans and many of which apply to state and local government plans. It also has provisions, enforced by the Department of Labor, from which state and local government plans are exempt.*

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

[9] *Sections of ERISA that amend much of the IRC do apply to public-sector plans. Government plans are exempt from most of ERISA's reporting, disclosure, and funding requirements and plan termination insurance.*

[10] *The IRC identifies any retirement plan established and maintained by a federal, state, or local government or by an agency or instrumentality of such governments as a "governmental plan."*

tion rules for both private- and public-sector plans in the years following the establishment of ERISA.[11]

Changes to Tax Law

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 for employment-based benefit plans (Crane, 1999; Harris, 2000; and EBRI, 1997). Unlike ERISA, many of these provisions do apply to state and local plans. This expansion into the operations of state and local pension plans can be found in the following federal tax and civil rights protection laws, including:

- *Tax Reform Act of 1986 (TRA '86)*—Substituted age 62 for Social Security normal retirement age, in recognition of earlier retirement ages for some public-sector occupations, imposed pre-TRA '86 Sec. 415 limits (on participant benefits and their contributions to pension plans for federal tax purposes)[12] on public plans; barred further creation of 401(k) plans in the public sector (several states had formed 401(k) plans for their workers before this law was enacted); and imposed required and minimum distribution rules (Sec. 401(a)(9)) and compensation limits (Sec. 401(a)(17)).

- *Age Discrimination in Employment Act (ADEA)*—Amendments to this law in 1988 extend ADEA protections, such as prohibitions against pension discrimination on the basis of age, to pension plans of governmental entities.

- *Omnibus Reconciliation Acts (OBRA) of 1990 and 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.

- *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,[13] or an annuity, and modified Sec. 415 limits to exclude their application to public-sector plans.

- *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 in certain conditions.

- *The Economic Growth and Tax Relief Reconciliation Act of 2001*—See Appendix.

This list suggests the degree to which federal legislation has influenced public-sector employers in

[11] *Beginning in 1977, the Internal Revenue Service (IRS) began a 12-year moratorium on disqualifying public retirement systems for violating applicable qualification rules. In May 1989, the IRS lifted the moratorium on adverse qualification decisions based on discrimination requirements and determined that these plans must satisfy certain nondiscrimination requirements (*Federal Register*, 1989). In May 1990, proposed rules were issued by the IRS on coverage, participation, and general nondiscrimination, which explicitly provided for transition rules for public-sector plans in order to give them sufficient time to comply (*Federal Register*, 1990). Final transition rules were never issued by the IRS. In 1997, Congress enacted the Taxpayer Relief Act of 1997 (TRA '97), which provided full relief from the nondiscrimination rules for state and local governments. In 1999, the 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 Jan. 1, 2001. IRS Notice 2001-9 extended this compliance date until Jan. 1, 2002.*

[12] *See Harris (2000) for a discussion of the history and development of Sec. 415 limits.*

[13] *Legislative interest in Sec. 457 plans was sparked in 1994 by the losses of Sec. 457 plan participants in Orange County, CA, 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; NAGDCA, 2001).*

retirement system operation and employee benefits provision. Moreover, in many areas of retirement plan operations, some combination of federal and state/local provisions can apply. This can be seen for the following areas:[14]

- *Participation and coverage requirements*—Federal nondiscrimination rules under ERISA are generally inapplicable to state and local government plans. Governmental plans *other* than state and local plans are currently exempt from compliance with the nondiscrimination rules until Jan. 1, 2002 (IRS Notice 2001-9). State and local participation and coverage laws are sometimes based on occupation-specific characteristics (e.g., related to the physical demands of public safety employees), and plans generally cover all full-time employees within an occupational classification.

- *Funding*—Federal law is not applicable, but state and local retirement plans must comply with certain pre-ERISA requirements of the IRC. State and local laws generally stipulate that funding cover the normal cost and the amount necessary to amortize the unfunded liability of a defined benefit plan.[15]

- *Fiduciary duties*—Two specific parts of the tax code address fiduciary duties: Sec. 401(a)(2) (no part of plan assets may be used for purposes other than the "exclusive benefit" of employees and beneficiaries, known as the "exclusive benefit" rule) and Sec. 503 (prohibited transaction rules for state and local plans). In addition, states and localities have largely adopted the private-sector ERISA standard with respect to investment practices.[16]

- *Vesting*—Federal law does not apply except to the extent that state and local plans must comply with vesting requirements of the IRC (Sec. 401(a)) in effect before ERISA. State and local jurisdictions regulate vesting through their own statutes.

- *Portability*—Federal rollover rules (Sec. 401(a)) apply, and, until 2001, state and local workers could not move retirement benefits between the different varieties of deferred compensation plans such as Sec. 401(k) (for the private sector), 403(b) (for educational and nonprofit organizations), and 457 (governmental) plans. However, under state and local law, employees are 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.[17]

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.[18] Because more federal initiatives in these areas have occurred, a further reduction in state-

[14] *List suggested by Moore (1999b).*

[15] *Private-sector employers generally contribute enough annually to a DB plan to cover the normal cost of the plan—an amount equal to at least the value for the benefits that participants in the plan have earned that year. In addition, employers may have to make additional contributions (e.g., to make up for investment losses). Failure to make legally required contributions exposes the employer to taxes for each year the liability exists (Krass, 2000).*

[16] *Moore (2000) reports that for state retirement systems that included teachers, as of 2000, 36 systems used a standard nearly identical to ERISA or the prudent investor standard, nine systems used a prudent person standard, and all but one of the remaining systems used some variation of a prudence rule.*

[17] *For example, at the state level, most public school teachers can purchase out-of-state teaching service credit. Interstate as well as intrastate reciprocity, where retirement systems are authorized to transfer participants' credit to other retirement systems, is sometimes available (Moore, 1999a).*

[18] *A qualified private-sector retirement 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 retirement 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 to state and local plans is the third one that defers a participant's liability for federal tax on the pension accrual until he/she takes a distribution.*

Table 1
Number of State and Local Retirement Systems and System Participants, Selected Years: 1962–1999

	1962	1967	1972	1977	1981	1985	1990	1992	1997	1998	1999
Total Number of Plans	2,346	2,165	2,304	3,075	3,075	2,589	2,387	2,307	2,276	2,140	2,211
State Administered	na	na	na	na	na	na	na	na	212	214	213
Locally Administered	na	na	na	na	na	na	na	na	2,064	1,926	1,998
County	na	na	na	na	na	na	na	na	150	147	150
Municipality	na	na	na	na	na	na	na	na	1,677	1,565	1,618
Township	na	na	na	na	na	na	na	na	159	146	156
Special district	na	na	na	na	na	na	na	na	62	54	60
School districts	na	na	na	na	na	na	na	na	16	14	14
					(thousands)						
Total System Participants	5,367	7,068	9,089	10,951	14,687	15,234	16,858	18,310	20,385	21,596	21,712
Active members[a]	na	na	na	na	10,330	10,364	11,345	11,998	12,817	13,059	13,481
Inactive members[b]	739	1,030	1,463	2,271	na	na	na	na	2,377	3,156	2,725
Beneficiaries	na	na	na	na	na	na	na	na	5,191	5,381	5,506

Sources: Data for years 1962–1977 taken from the *Statistical Abstract of the United States;* years beginning with 1981 taken from unpublished data, 1993–1996, U.S. Department of Commerce, Census Bureau; U.S. Department of Commerce, Census Bureau, *Finances of Employee-Retirement Systems of State and Local Governments*, selected years 1982–1991 (Washington, DC: Government Printing Office, 1984–1994); Census of Governments, Government Finances, Employee Retirement Systems of State and Local Governments, 1987, 1992, 1994, and 1998 (Washington, DC: U.S. Government Printing Office, 1989, 1994, 1996, and 2000).

[a] Current workers and/or contributors to the system.

[b] Former contributors who have left the system.

"na" indicates data not available for that year.

specific features of these systems is expected. However, as described in the following sections, the development of plan features and management of plan operations still rely extensively on state and local customs.

Systems at Work

The public sector is characterized by a relatively small number of large systems and a large number of small systems. According to the U.S. Census Bureau, there were 2,211 state- or local-level retirement systems nationwide in 1999, with the 213 systems administered at the state level accounting for slightly more than 88 percent of the total covered civilian public-sector population (U.S. Department of Commerce, 2000). Public employee retirement systems range in size from those with several hundred thousand participants (e.g., statewide retirement systems) to plans covering fewer than five employees (e.g., plans in townships or boroughs). There are fewer *general* coverage systems than there are *limited* coverage (chiefly occupation-specific) systems in operation. Table 1 provides historical data on the number of pension plans and participants for selected years beginning with 1962.[19]

Data in table 1 indicate an overall increase in the number of retirement systems in the 1970s, and growth in public employee membership during the 1960s and 1970s. The number of systems increased in spite of a considerable amount of consolidation taking place among public plans, as many larger pension systems brought smaller plans under their coverage. The latter was an effort designed to take advantage of economies of scale and new technologies (Mitchell et al., 1999).[20] This consolidation, particularly in the early 1980s, resulted in a decline in the total number of systems, with many local systems absorbed into state-administered systems in Pennsylvania, Kentucky, and Colorado (Phillips, 1992). Membership expansion in the 1970s reflected the enormous increase in employment as a result of a greater demand for government services, increasing government salaries, and the emergence of strong public employee unions (Munnell and Connolly, 1979). Since 1981, the percentage increase in employees (and beneficiaries) has been more modest.

The fluctuation over time in the number of systems is somewhat deceiving. Because retirement programs at the local level are generally smaller, their continued existence is less certain, owing to possible

[19] *A consistently reliable database on the numbers and types of pension systems is not available for the entire period. For that reason, data from the* U.S. Statistical Abstract *for 1962–1977 are appended to selected years from an EBRI database extended to 1981. The detail provided for the last three years in Census Bureau data may eventually be available for earlier years, according to sources in that agency.*

[20] *The expected results were not evident, according to a 1978 congressional report (U.S. Congress, 1978).*

changes in political boundaries and/or merger into larger, more established pension systems.[21] The number of state-administered systems indicated in table 1 is also somewhat deceptive, as the true variety in operation is undercounted in several ways. First, only those pension plans satisfying certain criteria are counted as state-administered plans. By definition, these criteria include: (1) plans sponsorship by a recognized unit of government as defined by the Census Bureau, and (2) plan membership consisting of public employees compensated with public funds (U.S. Department of Commerce, 2000).[22] Second, while administration at this level may include general coverage plans, the trend has been to administer several occupation-specific plans within an overall state-run enterprise.[23] Finally, there is a series of less generous mini-plans or "tiers," which have been created in recent decades but apply only to newly hired public employees. Seeking to minimize compensation costs, public-sector authorities have created these plans to provide less generous benefits to those employees. This form of retirement policy is rare in the private sector (Steffen, 1999).[24]

Multi-tier arrangements are evident in the state level data provided in table 2, which lists a range of pension plans for each of the various states. Where a particular retirement program operates several tiers with varying benefit levels, the added complexity is noted by the associated pension plans in parentheses. Over time, the combination of mergers and subsystems has led to a layering of retirement plans, which only begins to indicate the level of complexity of plans offered at the state level (e.g., it does not take into account the supplementary pension plans offered by all states).

Nearly all state and local employers sponsor defined benefit (DB) retirement plans for their workers, although defined contribution (DC) plans are becoming more common.

Plan Features

Since public retirement systems developed early and more or less independently from those established in private business, it is not surprising that, taken together, they exhibit a certain family resemblance that sets them apart in important respects from private-sector programs. The section briefly summarizes the common features of public-sector plans at the state level, and then explains how they differ from private-sector retirement plans. While as much detail is provided as possible, data for smaller, local plans are not always available.

Coverage and Participation

State and local retirement plans generally cover all full-time employees, and in some cases extend coverage to part-time and even seasonal employees. According to federal data in table 3, approximately 90 percent of the state and local work force in the early 1990s worked for an employer that offered a plan, an increase from the 1980s.

Table 3 data also show that, overall, about three-fourths of state and local employees participated in a retirement plan, and more than 80 percent of employees

[21] *This occurred with the consolidation in the 1980s. Several states now operate or coordinate a statewide system that may offer general or occupation-specific coverage for both state and local public-sector employers.*

[22] *In addition, each retirement system must be a separately identifiable fund within a recognized unit of government and be financed either whole or in part by public employee contributions. More detail on these criteria is available in "Technical Documentation" for the Annual Survey of State and Local Government Employee Retirement Systems on-line at www.census.gov/govs/www/retiretechdoc.html*

[23] *Following the 1980s consolidation wave, larger systems did not produce the benefits expected. In fact, they proved to be more complicated to administer because of the complexity of managing benefits for multiple and divergent employee groups often with very distinct plan provisions (Mitchell et al., 1999).*

[24] *ERISA and IRS rules require private-sector employers to guarantee that no employee will lose an already earned benefit entitlement. However, an employer is allowed to modify or terminate future accruals to both current and new employees. This differs from public-sector employers at the state and local level, where it is virtually impossible to change future benefit accruals for existing employees (Steffen, 1999). Instead, current employees remain under the old system, while changes in plan design apply only to new hires.*

Table 2
Variety of State-Administered Retirement Systems, 2001

State	Systems (acronym of larger system and/or tiers for successive groups of newly hired employees)
Alabama	Employees' Retirement System (ERS), Teachers' Retirement System (TRS), Judicial Retirement Fund
Alaska	Public Employee Retirement System - PERS (I-III), Teachers' Retirement System – TRS (I/II), Judicial Retirement System, Elected Public Officers Retirement System, National Guard and Naval Militia Retirement System
Arizona	State Retirement System (ASRS), Correctional Officers Retirement System (CORS), Elected Official Retirement System (EORS), Public Safety Retirement System (PSRS)
Arkansas	Public Employee Retirement System (PERS), Teacher Retirement System (ATRS)
California	Teachers Retirement System-CalSTRS, Public Employees' Retirement System-CalPERS (I/II), Legislators Retirement System, Judges Retirement System (I/II), CalSTRS' Part-time, Seasonal & Temporary Employee (PST) Retirement (Cash Balance) Plan, Peace Officers & Firefighters DC Program
Colorado	Public Employees Retirement Association (PERA), County Officials & Employees Retirement Association-CCOERA, Fire & Police Pension Association (I/II)
Connecticut	Teachers' Retirement System (TRS), Municipal Employees' Retirement System, State Employees' Retirement System
Delaware	State Employees' Pension Plan (SEPP), State Police Plan (I/II), Judicial Plan (I/II), County & Municipal Pension Plan (general & police/fire), Diamond State Port Corporation Pension Plan
Florida	Florida Retirement System (FRS), Municipal Police & Fire Pension Plan, Municipal Employee Retirement System, State University Optional Retirement Program
Georgia	Employees Retirement System-ERS (2 tiers), Teachers Retirement System (TRS), Public School Employees Retirement System (PSERS), Georgia DC Plan, Legislative Retirement System, Judicial Retirement System
Hawaii	Employees Retirement System (ERS)
Idaho	Public Employees Retirement System (PERS), Judges Retirement System, Municipal Police Officer Retirement Funds (I/II/III)
Illinois	Teachers' Retirement System (TRS), State Employees' Retirement System (SERS), State University Retirement System (SURS), General Assembly Retirement System, Municipal Retirement Fund (IMRF), Public Pension Fund Association, Judges Retirement System
Indiana	Public Employees' Retirement Fund (PERF), Teachers' Retirement Fund (TRF), Police Officers & Firefighters Disability & Pension Fund
Iowa	Public Employees Retirement System (PERS), Judicial Retirement System, Peace Officer Retirement System
Kansas	Public Employees Retirement System (PERS)
Kentucky	Teachers' Retirement System (STRS), Employees Retirement System (KERS), County Employees Retirement System (CERS), State Police Retirement System
Louisiana	State Employees Retirement System-LASERS (multi), Teachers' Retirement System (TRSL)
Maine	State Retirement System (MSRS)
Maryland	Teachers Retirement System (TRS), Teachers Pension System (TPS), Employees Retirement System (ERS), Employees Pension System (EPS)
Massachusetts	Teachers Retirement System (TRS), State Employees Retirement System-SERS (106 participating plans)
Michigan	Municipal Employees Retirement System (MERS), Public School Employees Retirement System (MPSERS), State Employees Retirement System-MSERS (DC/DB), Judges Retirement Board (DC/DB), State Police Retirement Board, Legislators Retirement Board (DC/DB)
Minnesota	Teachers Retirement Association (TRA), Public Employees Retirement Fund (PERF), State Employees Retirement Fund (SERF)
Mississippi	Public Employees Retirement System (PERS), Highway Safety Patrol Retirement System, Municipal Retirement Systems (several), Optional Retirement Plan
Missouri	State Employees' Retirement System (MOSERS), Public School Retirement System (PSRS), Non-Teacher School Employee Retirement System (NTRS), Local Government Employment Retirement System
Montana	Public Employees' Retirement System (PERS), Teachers' Retirement System (TRS), Sheriffs' Retirement System, Highway Patrol Officers' Retirement System, Firefighters' Unified Retirement System, Game Wardens' & Peace Officers' Retirement System, Judges' Retirement System, Municipal Police Officers' Retirement System, Volunteer Firefighters' Compensation Act
Nebraska	School Retirement System (SRS), State Employees' Retirement System (SERS), University of Nebraska Basic Retirement Plan (I/II)
Nevada	Public Employees' Retirement System (PERS)
New Hampshire	New Hampshire Retirement System-NHRS (I/II)
New Jersey	Public Employees Retirement System (PERS), Teachers' Pension & Annuity Fund (TPAF), Police & Firemen's Retirement System, Prison Officers' Pension Fund, State Police Retirement System, Judicial Retirement System
New Mexico	Public Employees' Retirement Association-PERA (I/II/III), Educational Retirement Board (ERB)
New York	Teachers' Retirement System (TRS), Employees' Retirement System (ERS), Police & Fire Retirement System
North Carolina	Teachers' & State Employees' Retirement System (TSERS), Local Governmental Employees' Retirement System (LGERS), Consolidated Judicial Retirement System, Firemen & Rescue Squad Workers' Pension Fund, Legislative Retirement Fund, Legislative Retirement System, National Guard Pension Plan

(continued)

Table 2 (continued)

State	Systems (acronym of larger system and/or tiers for successive groups of newly hired employees)
North Dakota	Teachers' Fund For Retirement (TFFR), Public Employees' Retirement System (PERS DB), Public Employees' Retirement System (PERS DC), National Guard Retirement Plan, Judges Retirement Plan, Highway Patrol Retirement Plan
Ohio	Public Employees Retirement System (PERS), School Employees Retirement System (SERS), State Teachers Retirement System (STRS), Police & Firemen's Disability & Pension Fund
Oklahoma	Public Employees' Retirement System (PERS), Teachers' Retirement System-TRS (I/II), Uniform Retirement System for Justices & Judges
Oregon	Public Employees Retirement System-PERS (I/II)
Pennsylvania	Municipal Retirement System (PMRS), State Employees Retirement System (SERS), Public School Employees' Retirement System (PSERS)
Rhode Island	Employees Retirement System (ERSRI), Municipal Employees Retirement System (MERS)
South Carolina	State Retirement System-SCRS (2 tiers DB), State Optional Retirement Program (DC), Police Officers' Retirement System (2 tiers DB), General Assembly Retirement System, Judges' and Solicitors' Retirement System
South Dakota	State Retirement System-SDRS (I/II)
Tennessee	Consolidated Retirement System (TCRS)
Texas	Employees' Retirement System (ERS), Teachers' Retirement System (TRS), Municipal Employees Retirement System
Utah	Public Employees Retirement System-PERS (DB contributory), Public Employees Retirement System -PERS (DB noncontributory), Firefighters Retirement System, Public Safety Retirement System, Judges Retirement System, Governors & Legislative Plan
Vermont	State Retirement System-VSRS (6), State Teachers' Retirement System-STRS (I/II/III), Municipal Employees' Retirement System-MERS (I/II/III)
Virginia	State Retirement System (VRS)
Washington	Public Employees Retirement System-PERS (Plan 2 or 3), Teachers' Retirement System-TRS (I/II/III), School Employees' Retirement System (SERS), Law Enforcement Officers' & Firefighters' Retirement System (I/II), State Patrol Retirement System, Judges' Retirement Fund, Judicial Retirement System
West Virginia	Teachers' Retirement System-TRS DC, Teachers' Retirement System -TRS DB, Public Employees Retirement System (PERS), State Police Retirement System, Public Safety Death, Disability, & Retirement System, PERS, Judges Retirement System, Deputy Sheriff Retirement System
Wisconsin	State Retirement System (WRS)
Wyoming	State Retirement System (WRS)

Source: Compiled by EBRI staff. Note: Numbers in parentheses denote multiple subsystems.
Common Abbreviations: PERS=Public Employee Retirement System; ERS=Employee Retirement System; TRS=Teacher Retirement System; STRS=State Teachers Retirement System; RS=Retirement System; RP=Retirement Plan; PP=Pension Plan; DC=defined contribution; DB=defined benefit.

in state and local entities that sponsored retirement programs from 1983 to 1993 actually participated.[25] According to more recent survey data collected by the U.S. Department of Labor, among full-time workers in 1998, nearly all of state and local government employees participated in one or more employment-based retirement plans.[26] For both full- and part-time workers, the combined percentage has been estimated at just above

Table 3

Trends in Retirement Plan Sponsorship and Participation Among Civilian Nonagricultural Wage and Salary Workers Age 16 and Older in State and Local Government, 1983, 1988, 1993

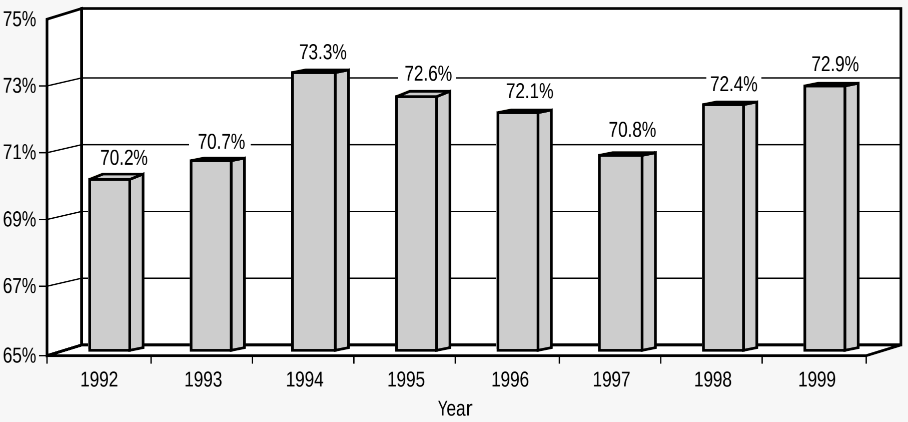
	Sponsorship Rate[a]	Participation Rate	Sponsored Participation Rate[b]
1983	82%	72%	88%
1988	92	76	83
1993	89	74	83

Source: Employee Benefit Research Institute tabulations of the May 1983, May 1988, and April 1993 *Current Population Survey* employee benefit supplements.
[a]The fraction of workers whose employer or union sponsors a plan for any of the employees at the workers' place of employment.
[b]The fraction of workers participating in a plan among those whose employer or union sponsors a plan for any of the employees at the workers' place of employment.

[25] *Based on Current Population Survey reports for various years.*

[26] *Retirement plans are typically classified as either defined benefit (DB) or defined contribution (DC). They differ in several important ways (VanDerhei and Copeland, 2001). In a DB plan, the benefit at retirement is specified by a formula, and the employer bears the investment risk to fund the benefit. Contributions can be paid by either or both parties and are held in one trust on behalf of all employees. Furthermore, DB plans tend to offer lifetime annuities. In a DC plan, the cost (contribution) is specified to the employer and/or employee, and usually all contributions are placed in individual accounts on behalf of each participant. The majority of DC plans offer participants a choice of account investment options, and plan participants assume all investment risk, as benefits are determined by plan contributions and investment returns on account assets. Finally, DC plans usually offer lump-sum benefits (paid out at one time).*

Chart 2
Percentage of State and Local Government Workers Participating in a Retirement Plan, 1992–1999



Source: Employee Benefit Research Institute estimates of the 1993–2000 March Current Population Surveys.

Table 4
Percentage of Full-Time and Part-Time Employees Participating[a] in Employee Benefit Programs: State and Local Governments,[b] 1990, 1992, 1994, and 1998

	Full-Time Employees				Part-Time Employees			
Retirement Income Benefits[c]	1990	1992	1994	1998	1990	1992	1994	1998
All Retirement[d]	96%	93%	96%	98%	48%	51%	58%	62%
Defined benefit pension	90	87	91	90	45	48	55	59
Defined contribution	9	9	9	14	3	4	5	5
types of plans								
savings and thrift	1	2	2	5	1	1	1	1
money purchase pension	8	7	7	10	2	3	3	4
Cash or deferred arrangements								
with employer contributions	na	na	7	13	na	na	3	4
salary reduction	na	na	2	6	na	na	11	15
savings and thrift	na	na	2	4	na	na	na	na
other[e]	na	na	5	7	na	na	na	na
no employer contributions	na	na	5	22	na	na	na	na

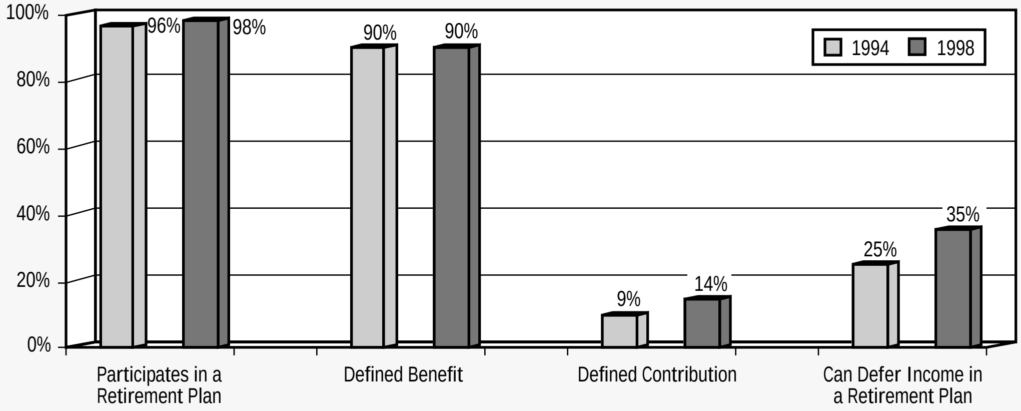
Source: U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments*, 1990, 1992, 1994, and 1998 (Washington, DC: U.S. Government Printing Office, 1992, 1994, 1996, and 2000).
Note: Because of rounding, sums of individual items may not equal totals.
[a] Includes workers covered but not yet participating due to minimum service requirements. Does not include workers offered but not electing contributory benefits.
[b] BLS's survey scope was expanded significantly in 1990 to include part-time workers, all governments regardless of size, and Alaska and Hawaii.
[c] Includes only benefits that are partly or wholly employer-paid.
[d] Includes defined benefit pension plans and defined contribution retirement plans. The total is less than the sum of the individual items because many employees participated in both types of plans.
[e] Includes money purchase pension plans.
"na" refers to data not available.

70 percent during 1992–1999 (see chart 2).

Nearly all state and local employers sponsor defined benefit (DB) retirement plans for their workers, although defined contribution (DC) plans are becoming more common. Table 4 shows that the DB plan has been predominant for both full- and part-time eligible employees throughout the 1990s. Ninety-eight percent of full-time employees participated in a retirement plan in

Chart 3

Estimated Percentage Participating Among Full-Time Employees of State and Local Governments, by Retirement Plan and Type, 1994 and 1998



Source: U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments*, 1994 and 1998 (Washington, DC: U.S. Government Printing Office, 1996 and 2000).

1998. Ninety percent of full-time employees were in a DB plan and 14 percent were in a DC plan.[27] Part-time rates were 59 percent in a DB plan and 5 percent in a DC plan.

Prior to 1998, there was an increase in DC participation among both full- and part-time employees. For full-time employees, participation rates rose from 9 percent in 1994 to 14 percent in 1998 (see chart 3). During this time, DB participation by full-time workers remained steady at 90 percent. In addition, the data show that over a third of full-time employees (35 percent) were able to defer a portion of their current earnings (thereby sheltering the income from current income taxes) by contributing to some type of cash or deferred arrangement in 1998, compared with one-quarter in 1994.[28] These arrangements often take the form of a salary reduction plan, which allows employees to contribute part of their earnings toward retirement but defers income taxes on those contributions and their earnings until distribution. Latest data indicate 35 percent of all full-time employees participated in such an arrangement, with 13 percent receiving an employer contribution and 22 percent receiving no employer contribution. (U.S. Department of Labor, 1996).[29] The increased participation from 1994 to 1998 in these plans suggests that state and local employees are being given increased opportunities and/or are taking advantage of such opportunities provided through supplemental DC pension plans.[30] Part-time employees participate at relatively lower levels, but also increased their participation rates in DB plans from 45 percent in 1990 to 59 percent by 1998. Participation in DC plans among part-time workers rose from 3 percent in 1990 to 5 percent in 1998 (table 4).

Participation for full-time employees also can be viewed by occupational group (table 5 and table 6). Table 5 shows that a benefit design consisting of a solitary DB plan (with no other plan) prevailed throughout the early 1990s, and actually increased among teachers and blue-collar workers while falling slightly among white-collar employees by 1994. At the same time, little change in general occurred for employees with a money purchase plan, which was the only type of coverage for about two-thirds of those in that type of plan. However, this masked a shift in type of coverage by occupation. For example, the share of white-collar employees with a money purchase plan and no other plan fell, while it rose for both teachers and blue-collar employees. At the same time, the share of employees participating in both a DB and a DC plan increased among white-collar employees, but fell for the other occupational groups. Comparing table 6 with 1998 data in table 4 shows that a slightly higher percentage of white-collar employers participate in DC plans, including cash or deferred arrangements with an employer contribution.

[27] *These percentages do not sum to 100 percent, since employees can participate in both types of plans.*

[28] *Cash or deferred arrangements are authorized under several sections of the IRC, including 401(k), 457, and 403(b).*

[29] *In table 4, the 13 percent of cash or deferred arrangements with employer contribution comprise the bulk of the 14 percent listed separately for DC plan participation in 1998.*

[30] *Participation in DC plans has risen, but not to the detriment of DB plans.*

Table 5
Percentage of Full-Time Participants by Selected Plan Types and Combination of Plans, State and Local Governments, 1990, 1992, and 1994

	All Participants			White-Collar Participants Except Teachers			Teachers			Blue-Collar and Service Participants		
	1990	1992	1994	1990	1992	1994	1990	1992	1994	1990	1992	1994
Defined Benefit	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
With:												
No other plan	97	97	97	98	98	96	94	97	98	91	97	96
Savings and thrift	a	1	1	1	1	2	a	a	1	1	1	1
Money purchase	3	2	b	1	1	b	5	3	b	8	3	3
Other combinations	b	a	2	b	a	2	b	a	1			
Money Purchase Pension	100	100	100	100	100	100	100	100	100	100	100	100
With:												
No other plan	66	62	67	79	69	71	50	66	67	38	50	56
Defined benefit	32	22	29	17	11	25	50	33	29	60	29	40
Savings and thrift	2	15	b	4	20	b	b	1	b	1	21	b
Other combinations	b	a	3	b	1	4	b	b	a	b	b	4

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments, 1990, 1992, and 1994* (Washington, DC: U.S. Department of Labor, 1992, 1994, and 1996).
[a]Less than 0.5 percent.
[b]Data not available.

Deferred Compensation Plans

The concept of deferred compensation plans originated from Private Letter Rulings of the Internal Revenue Service (IRS) for individual private-sector retirement plans. Applications from the public sector began in 1968 with a government employer in Utah and by 1977 spread to other localities and 22 states. In 1978, Congress enacted a new law (Revenue Act of 1978), which led to Sec. 457 of the IRC, paralleling a similar provision (Sec. 401(k)) for the private sector and explicitly authorizing salary deferral plans for the public sector (NAGDCA, 2000; DuBrin, 1979).

When Sec. 457 was added to the IRC, about one-half of the states provided a voluntary DC plan. By 1988, voluntary DC plans were available to public-sector employees in all 50 states (U.S. GAO, 1999). However, only a handful of states contribute to these programs, much like an employer match in a 401(k) plan.[31] In the 1990s, several states and localities included a DC plan as another component in the overall benefits design, although few used it as their primary retirement program. More recently, some states have permitted employees to choose between a DB and DC alternative (see page 22 for 403(b) plans; table 15 for state-by-state changes).

Contributions

A strong majority (78 percent) of eligible DB plan participants at the state and local levels contributed to plans in 1998 (U.S. Department of Labor, 2000), with teachers contributing at the highest rate (88 percent). According to a 2001 study, 44 out of 50 statewide general coverage retirement systems currently require contributions from employees (Workplace Economics, Inc. 2001). Occasionally, states "pick up" the employee contribution.[32] A recent National Education Association report on large public (statewide) plans noted that, among systems requiring employee contributions, the median contributed by employees is 5 percent of salary, while the employer share ranges from zero to 18.75 percent of covered payroll (National Education Association, 2000). Among general statewide plans in 2001, the level of

[31] *A 1999 survey conducted by the National Association of Government Deferred Compensation Administrators (NAGDCA) found that eight local and six state governments had Sec. 457 match plans. Reported employee participation rates were approximately 55 percent for states and 55 percent for local governments, respectively, offering the match. For jurisdictions not offering a match, participation rates were 25 percent for state and 49 percent for local governments—a combined 37 percent participation rate (NAGDCA, 2000).*

[32] *Employer "pick up" is permitted under IRC 414(h) provisions. Employee contributions are picked up by the public employer presumably in lieu of a salary increase, or the employee may continue to make contributions but on a tax-sheltered basis. In either case net pay is greater due to federal/state tax sheltering. The State of Wisconsin,* 1996 Comparative Study of Major Public Employee Retirement Systems, *singled this activity out as a significant trend (State of Wisconsin, 1996).*

Table 6
Percentage of Full-Time Employees Participating[a] in Retirement Programs: State and Local Governments, 1998

	All Employees	White-Collar Employees Except Teachers	Teachers	Blue-Collar and Service Employees
All retirement[b]	98%	98%	98%	98%
Defined benefit pension	90	89	92	91
Defined contribution	14	15	11	14
types of plans				
savings and thrift	5	5	1	6
money purchase pension	10	11	9	10
Cash or deferred arrangements				
with employer contributions	13	14	10	13
salary reduction	6	6	5	7
savings and thrift	4	5	1	6
money purchase	1	c	3	1
other[d]	7	9	5	7
no employer contributions	22	22	25	19

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Compensation and Working Conditions*, Vol. 5, Summer 2000 (Washington, DC: U.S. Government Printing Office, 2000).
Note: Because of rounding, sums of individual items may not equal totals.
[a] Includes workers covered but not yet participating due to minimum service requirements. Does not include workers offered but not electing contributory benefits.
[b] Includes defined benefit pension plans and defined contribution retirement plans. The total is less than the sum of the individual items because some employees participate in both types of plans.
[c] Less than 0.5 percent.
[d] Includes required contributions made to money purchase pension plans on a pre-tax basis.

employee contribution ranges from 1.25 percent to 9.75 percent of salary in states requiring such contributions, while the overall level of state contribution varies from zero to 19.38 percent of covered wage (Workplace Economics, Inc., 2001).

Vesting

The term "vesting" refers to an employee's right, after satisfying some minimum service requirement, to receive a pension benefit regardless of whether that employee remains in covered employment. Almost all state and local DB plans require some form of cliff vesting (table 7).[33] Absent an age requirement, slightly more than half of participants are vested at five years or less. This is the same percentage reported in 1994 (U.S. Department of Labor 1996). Vesting at 10 years occurs in 40 percent of plans—a slight decrease from the 1994 figure. As shown in table 7, occupations report comparable vesting requirements and a similar profile can be seen with the five-year and 10-year requirement across occupational groups. In 2001, data on vesting requirements for general statewide retirement plans indicate that 12 states require 10 years of service before an employee is fully vested, two states require eight years for vesting, another 27 states use a five-year vesting period, and eight states vest in less than five years (Workplace Economics, Inc., 2001). A National Education Association survey of large public plans, including general coverage and teacher systems, found that full vesting after five years occurred in 51 percent of the plans and after 10 years in 28 percent of the plans surveyed (National Education Association, 2000).

Age and Minimum Service Period

Most state and local DB plans either require employees to reach a minimum age before retiring with full benefits or specify the number of service years to retirement (table 8). Still other DB plans provide for full retirement based on some specified combination of service years and age—for example, a combined total of 80 or 85. These latter combinations are sometimes referred as the Rule of 80 and the Rule of 85, respectively.

Normal full retirement (unreduced benefit) is available in many state and local retirement plans at age 60 or 62. Tables 8 and 9 display normal and early retirement requirements, respectively, for full-time employees in DB plans. For normal retirement (table 8), there is no age requirement for 41 percent of plan

[33] *Under a cliff vesting schedule, an employee is not entitled to any benefits accrued under a pension plan until satisfying the requirement for 100 percent vesting.*

Table 7

Percentage of Full-Time Employees Participating in Defined Benefit Pension Plans,[a] by Type of Vesting Requirements: State and Local Governments, 1998

Vesting Requirements	All Employees	White-Collar Employees Except Teachers	Teachers	Blue-Collar and Service Employees
Total[b]	100%	100%	100%	100%
Cliff Vesting	100	100	100	100
Cliff Vesting With Full Vesting				
At any age	100	100	100	99
less than 5 years of service	4	6	2	4
5 years of service	48	46	51	47
6–9 years of service	5	7	4	5
10 years of service	40	40	41	38
more than 10 years of service	2	1	c	4
After specified age[d]	e	e	c	1
6–9 years of service	e	e	c	e
Graduated Vesting	e	e	c	e
Graduated vesting with full vesting after				
less than 7 years service	e	e	c	e
more than 7 years of service	e	e	c	e

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments*, 1998 (Washington, DC: U.S. Government Printing Office, 2001).

Note: These tabulations provide representative data for full-time employees in state and local governments in the 50 states and the District of Columbia. The estimated number of full-time workers employed by all surveyed firms was 12.5 million.

[a] Excludes supplemental pension plans.

[b] Because plans may adopt alternative vesting schedules, sums of participants covered by individual vesting schedules may exceed 100 percent.

[c] No employees in this category.

[d] Sponsors may exclude years of service completed before age 18 from counting toward the satisfaction of minimum vesting standards.

[e] Less than 0.5 percent.

participants, while 27 percent of employees are in plans with a 30-year service period. Normal retirement is provided at age 55 for 20 percent of plan participants and at age 60 for 10 percent. If age is disregarded, early retirement is permitted for 87 percent of plan participants (table 9). Twenty-six percent are allowed early retirement without an age requirement, 19 percent are permitted early retirement before age 55, and 40 percent at age 55. The combined sum of age plus service is offered for 13 percent of plan participants at normal retirement, but offered for only 1 percent under early retirement.

Defined Benefit Formulas and Replacement Rates

While few defined benefit calculation formulas are identical, nearly all state and local plans employ some variation of a terminal earnings formula to determine the proportion of preretirement earnings to be replaced by pension benefits. A terminal earning formula is also widespread across occupational groups (table 10). Most plans have a formula that specifies a percentage rate at which pension benefits accrue for each year of service, which is multiplied by the employee's total number of years' service, and in turn is then multiplied by the employee's average final compensation (based on a set number of years or months). For the majority of participants in state and local plans (75 percent), benefits are based on a flat percentage accrual rate, which averaged 1.9 percent in 1998 (U.S. Department of Labor, 2000).

When fewer years of service are considered, the dollar amount of the average benefit tends to be higher, reflecting the greater influence of the final years of employment—when earnings are generally higher (National Education Association, 2000). In addition, the accrual rates used in the retirement plan formulas tend to be higher in those plans where employees are not covered by Social Security. According to recent data from the National Association of State Retirement Administrators (NASRA), retirement formulas increased during the 1995–2001 period for larger statewide systems (NASRA, 2001).

As state retirement systems add more tiers (plans) for new hires, the likely trend is for different benefit formulas with less generous rates of accrual, depending on age and/or date of hire. Sometimes, retirement systems provide a minimum benefit to full-time employees with low earnings. For example, CalPERS (the California Public Employee Retirement System) provides a minimum benefit for employees who

Table 8

Minimum Age and Service Requirements for Normal Retirement for Full-Time Participants in Defined Benefit Pension Plans:[a] State and Local Governments, 1998

Age and Service Requirement[b]	
Total With Defined Benefit Plans	100%
No Age Requirement	41
Less than 20 years service	c
20–29 years of service	7
30 years of service	27
35 years of service	6
Under Age 55	1
No service requirement	c
5 years of service	c
20 years of service	c
21–24 years of service	c
25 years of service	1
30 years of service	c
At Age 55	20
No service requirement	1
5 years of service	2
10 years of service	1
20 years of service	1
25 years of service	6
30 years of service	10
More than 30 years of service	c
At Age 60	10
No service requirement	4
5 years of service	6
6–9 years of service	2
10 years of service	2
25 years of service	1
30 years of service	c
At Age 62	4
No service requirement	c
5 years of service	c
10 years of service	2
15 years of service	c
25 years of service	c
30 years of service	c
At Age 65	9
No service requirement	3
1–4 years of service	c
5 years of service	2
10 years of service	3
Sum of Age Plus Service	13
Equals less than 80	c
Equals 80	3
Equals 81–89	5
Equals 90	4

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments, 1998* (Washington, DC: U.S. Government Printing Office, 2000).

Note: These tabulations provide representative data for full-time employees in state and local governments in the 50 states and the District of Columbia. The estimated number of full-time workers employed by state and local governments was 12.5 million.

[a] Excludes supplemental pension plans.

[b] Normal retirement is defined as the point at which the participant could retire and immediately receive all accrued benefits by virtue of service and earnings without reduction due to age. If a plan had alternative age and service requirements, the earliest age and associated service were tabulated; if one alternative did not specify an age, it was the requirement tabulated.

[c] Less than 0.5 percent.

work more than 20 years; CalSTRS (California State Teachers Retirement System) has minimum benefit provisions for retired teachers with more than 15 years service.

Social Security Coverage and Participation

About one-fourth of all full-time workers in state and local DB plans are not covered by Social Security (Fore, 2001; Eitelberg, 1999). Examining employees participating in DB plans, the proportion not covered by Social Security is fairly consistent across all occupational groups at around 10 percent, although a little lower for white-collar employees (table 11). Among the 50 general coverage statewide retirement systems, 43 participate in Social Security. The remaining seven states with general coverage retirement systems not participating in Social Security include Alaska, Colorado, Louisiana, Maine, Massachusetts, Nevada, and Ohio. The delineation between these two groups is not exactly clean, however, since there are both large and small retirement programs not covered by Social Security, which operate in states where the general retirement programs are covered.[34]

In general-coverage statewide systems where employees receive both a state pension and a Social Security benefit, five offer some kind of coordinated or

[34] *For example, teachers in Connecticut, Kentucky, Illinois, Missouri, Texas, and California do not participate. Moreover, certain teachers in Rhode Island, Georgia, Oklahoma, and Minnesota also do not participate.*

Table 9

Minimum Age and Service Requirements for Early Retirement, for Full-Time Participants[a] in Defined Benefit Pension Plans:[b] State and Local Governments, 1998

Total With Defined Benefit Plan	100%
Participants in Plans Permitting Early Retirement	87
No Age Requirement	26
Less than 20 years of service	8
20–29 years of service	11
30 years' service	8
Under Age 55	19
5 years of service	6
10 years of service	4
15 years of service	2
20 years of service	5
25 years of service	c
30 years of service	2
Age 55	40
No service requirement	1
1–4 years of service	2
5 years of service	9
6–9 years of service	c
10 years of service	10
15 years of service	4
20 years of service	3
25 years of service	9
30 years of service	1
Age 60	1
5 years of service	c
10 years of service	1
20 years of service	c
Age 62	c
10 years of service	c
Sum of Age Plus Service	1
Equals less than 80	1
Early Retirement Not Available	13

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments, 1998* (Washington, DC: U.S. Government Printing Office, 2000).

Note: These tabulations provide representative data for full-time employees in state and local governments in the 50 states and the District of Columbia. The estimated number of full-time workers employed by state and local governments was 12.5 million.

[a] Early retirement is defined as the point at which a worker could retire and immediately receive accrued benefits based on service and earnings but reduced for each year prior to normal retirement age. If a plan had alternative age and service requirements, the earliest age and associated service were tabulated; if one alternative did not specify an age, it was the requirement tabulated.

[b] Excludes supplemental pension plans.

[c] Less than 0.5 percent.

Table 10

Percentage of Full-Time Defined Benefit Plan[a] Participants, by Method of Determining Retirement Payments: State and Local Governments, 1998

	All Participants	White-Collar Employees Except Teachers	Teachers	Blue-Collar and Service Employees
Total	100%	100%	100%	100%
Terminal Earnings Formula	99	100	98	97
Terminal earnings alternative	11	10	16	7
Career Earnings Formula	b	b	c	1
With alternative formula[d]	b	c	c	b
Cash account	1	b	b	1

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments, 1998* (Washington, DC: U.S. Government Printing Office, 2000).

Note: These tabulations provide representative data for full-time employees in state and local governments in the 50 states and the District of Columbia. The estimated number of full-time workers employed by state and local governments was 12.5 million. Because of rounding, the sum of individual items may not equal totals.

[a] Excludes supplemental pension plans.

[b] Less than 0.5 percent.

[c] No employees in this category.

[d] Alternative formulas are generally designed to provide a minimum benefit for employees with short service or low earnings.

Table 11

Provision for Integration of Defined Benefit Pension Plan[a] With Social Security Benefit, By Occupational Group, Full-Time Employees: State and Local Governments, 1998

Provision	All Employees	White-Collar Employees Except Teachers	Teachers	Blue-Collar and Service Employees
Total	100%	100%	100%	100%
With Integrated Formula	7	7	5	9
Offset by Social Security Payment	1	2	2	1
Step-Rate Excess	6	6	4	9
Integrated with Social Security breakpoint	3	2	2	5
Integrated with a specific dollar breakpoint	3	4	2	3
Without Integrated Formula	82	85	83	79
Not Covered Under Social Security	10	8	12	12

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments, 1998* (Washington, DC: U.S. Government Printing Office, 2000).

Note: These tabulations provide representative data for full-time employees in state and local governments in the 50 states and the District of Columbia. The estimated number of full-time workers employed by state and local governments was 12.5 million.

[a]Excludes supplemental pension plans.

integrated plan (Workplace Economics, Inc., 2001).[35] Government data indicate that integrated formulas are generally uncommon in such DB plans, accounting for 7 percent of the total (table 11). There are usually significant differences between the benefits received by employees from their government-sponsored retirement plan, depending on whether or not they are also covered by Social Security. Higher benefit formulas typically apply to employees without Social Security coverage in order to make up for the absence of those postretirement benefits. According to data from a survey of state and local government employee retirement systems conducted by the Public Pension Coordinating Council in 2000, the average annual unit benefit (percentage of final average salary used in the benefit formula for the first 10 years of service) of plans without Social Security coverage was 2.38 percent, compared with 2.08 percent for plans with Social Security coverage (Public Pension Coordinating Council, 2000).

Cost-of-Living Adjustments

Cost-of-living adjustment (COLA) provisions represent an effort on the part of public-sector employers to compensate retirees for the loss of purchasing power due to inflation. Inflation in the 1970s caused many public retirement plans to adopt COLAs to protect annuity purchasing power (State of Wisconsin, 1996). Some plans specify automatic cost-of-living increases, usually based on changes in the Consumer Price Index (CPI), while other plans provide discretionary (ad hoc) increases to adjust retiree benefits for inflation. According to government figures for 1998, COLA provisions existed in 55 percent of state and local plans (U.S. Department of Labor, 2000). The variety of approaches used by these plans is quite extensive.[36] In a study of large plans by the National Education Association, nearly all had some kind of COLA (National Education Association, 2000). Another study found that almost all general-coverage state systems provide some form of cost-of-living adjustment for retired workers in 2001, and there is an automatic procedure in 37 of these states (Workplace Economics, Inc. 2001). Of those that offer an automatic adjustment, 11 have some form of fixed percentage and the others tie changes to the CPI, although these calculations can differ considerably across states.

Purchase of Service Credit

In the absence of full portability of benefits, an opportunity to purchase credit for past service as a public employee can spell the difference between being eligible and not being eligible for retirement, especially for

[35] *Integrated plans are those that explicitly recognize Social Security coverage in the plan design by using "offsets" or "step-up formulas." "Offset" provisions subtract some part of the Social Security benefit from the state-provided retirement plan annuity upon Social Security retirement. By contrast, "step-up formulas" apply lower pension benefit rates to an employee's earnings up through a specified earnings level (for example, the Social Security taxable wage base) and then apply higher rates above that level.*

[36] *For example, these can vary on the basis of service period date of retirees, investment performance of the pension fund, and other characteristics.*

Table 12
Differences Between State and Local and Private-Sector Retirement Plans

Characteristic	Private Plans	State and Local Public Plans
Plan Provisions	Legal document conforming to federal law and regulations	Contained in state and local statutes; selective conformity to federal law and regulations
Predominant Type of Program	Defined contribution and defined benefit	Defined benefit
Coverage		
Work force	Not universal; general coverage	Nearly universal; both general and occupation-specific
Under Social Security	96 percent	75 percent
Under ERISA[a] provisions	Qualified plans only	Selectively
Employee Contributions		
To primary program	No	Usually
Mandatory	No	Usually
To supplemental program	Yes	Yes
Portability	401(k) rollover	401(k), 403(b), and 457 plan rollover available for defined contribution plans; defined benefit plans often allow purchase of service credits
COLA[b] Provisions	Rare or ad hoc	Common, may be automatic

Source: Adapted from Table 1 in Karen Steffen, *State Employee Pension Plans,* PRC Working Paper 99-5 (Philadelphia, PA: University of Pennsylvania, Pension Research Council, 1999).
[a] The Employee Retirement Income Security Act of 1974.
[b] Cost-of-living adjustment.

public-sector workers in several retirement systems. In 1998, 72 percent of full-time state and local employees in DB plans were allowed to purchase credits for prior government service, including white-collar employees (73 percent), teachers (77 percent), and blue-collar and service employees (65 percent), according to government statistics (U.S. Department of Labor, 2000). Plan provisions for teachers, for example, can differ as to the type of prior service available for purchase (e.g., from another state system), the amount paid for the purchase, and the payment options available (National Education Association, 2000). This aspect of public-sector plans has taken on increased importance in the education area, given the shortage of teachers in many states. As of 1998, 47 out of 50 statewide retirement systems (that include teachers) allowed some or all participants to purchase out-of-state teaching service credit.

Public- & Private-Sector Differences

There are major differences between state and local public-sector retirement programs and private-sector plans (table 12), as outlined below.

Plan Provisions

The single largest difference between public- and private-sector benefit programs lies in their relationship to the law and the legislative process. The special status of state and local pension plans stems from their relationship to two landmark federal laws: the Social Security Act of 1935 and ERISA. As mentioned earlier, the Social Security Administration currently estimates that about 5 million state and local employees, or about one-fourth of the total, are not covered by Social Security (Segal Company, 1999; Crane, 1999).[37] The DB nature of Social Security influences the overall benefits design provided to employees, since the public employer is obliged to take into account specified coverage, contributions, and other similar issues with respect to Social Security.

All qualified private-sector plans with tax-incentive features are regulated by the federal government (primarily by ERISA), but public-sector plans are not subject to all ERISA provisions.[38] The federal government has at times formally asserted that its tax laws and benefits regulations do apply to benefit plans for state and local employees, but occasionally its enforcement has been slow. Still, public-sector plans share with qualified private-sector plans a common source of rules under the federal IRC, which has been

[37] *The U.S. General Accounting Office estimated that 70 percent of state and local government employees are covered by Social Security. Seven states (California, Colorado, Illinois, Louisiana, Massachusetts, Ohio, and Texas) account for approximately 75 percent of the noncovered payroll. Note that this list is slightly different from that mentioned earlier, where only general coverage retirement systems were considered. The list of states is modified here by including occupation-specific (e.g., teacher) plans. Police, firefighters, and teachers are less likely to be covered by Social Security than are general employees (Zorn, 1999).*

expanded in recent years. Within these constraints, private-sector plan sponsors are relatively free to establish, maintain, and modify their plans as regulated by ERISA. This has given all tax-qualified private-sector retirement plans certain common characteristics.

By contrast, the basic features of public employee plans—eligibility, contributions, types of benefits, etc.—are often spelled out in state statutes or in local ordinances. Even where collective bargaining over benefit issues is allowed, legislatures generally retain some measure of control. Furthermore, public employee programs usually exist within a highly structured (civil service) personnel system that is itself prescribed, often in great detail, in public law (EBRI, 1997). In addition, because they are legislative products, public employee benefit plans necessarily reflect the interplay of political (rather than business) forces. Where public employee benefit plans are concerned, interest-group activities can usually extend far beyond the public administrators and employees (and their unions and associations) that are directly affected, and often include provider groups, insurers, the business and financial community, and taxpayer organizations. While the federal government has imposed regulations on state and local pension plans, the state-specific combination of forces can significantly influence plan specifics to a large extent. The result is a far greater range and variety of plan design within the public sector than in the private sector.

Predominant Type of Program

As mentioned earlier, public-sector employees are more likely to be covered by defined benefit pension plans than are workers in private-sector establishments employing 100 or more employees (establishments similar in size to state and local governments). In 1998, nine out of 10 full-time employees participated in defined benefit plans (the same percentage as in 1994), compared with 56 percent of private-sector employees in medium and large private establishments in 1993 (U.S. Department of Labor, 2000). Among full-time workers in 1994, 91 percent of state and local government employees participated in a defined benefit pension plan, compared with 56 percent of private-sector employees in medium and large private establishments in 1993 (U.S. Department of Labor, 1994 and 1996).

According to many analysts, reasons why DC plans in the private sector, and, to a lesser degree in the public sector, have become more attractive include the regulatory burdens and costs associated with ERISA,[39] booming stock markets, and a private-sector employer philosophy that views DC plans as a more flexible and appreciated benefit in changing labor markets (Steffen, 1999). A host of DC arrangements have arisen in both private- and public-sector plans in the last two decades as either supplements or replacements to traditional DB plans. As mentioned earlier, the most important of these for the private sector is Sec. 401(k) of the tax code; for the public sector, they are Sec. 403(b), and 457(b):

- Employers sponsoring 403(b) plans include hospitals, churches, and public-sector educational institutions such as colleges and universities.[40] Sec. 403(b) plans, also known as tax-deferred annuities (TDAs) and tax-sheltered annuities (TSAs) are qualified plans subject to IRS rules and may or may not be subject to ERISA, depending upon the type of plan.[41] Although these plans tend to be used as a voluntary supplement to an employment-based DB retirement plan in the case of kindergarten through grade 12 teachers, some are primary plans (as in the case of university personnel, where they involve both employer and employee contributions). There is usually no employer match for K-12 teachers.

- Sec. 457(b) plans have been available to state and local government employers since 1978. Unlike 401(k)

[38] *See footnote 9.*

[39] *Applies to the private sector, where rules are more numerous.*

[40] *To be eligible to sponsor 403(b) plans, employers must be nonprofit organizations that qualify as charitable organizations under IRC Sec. 501(c)(3) or an educational organization described in IRC Sec. 170(b)(1)(A)(ii).*

Another key difference between public- and private-sector plans is the requirement in many public-sector DB plans that employees contribute toward the cost of the plan.

and 403(b) plans that can be rolled over into an IRA or to any qualified pension plan, 457(b) plans lacked portability (until the 2001 tax law), because assets (employee contributions) could be transferred only to another 457(b) plan or left with the former employer until retirement (see Appendix). Their relative advantage is for employees who intend to retire early (especially in certain public safety occupations), since there is no penalty for early withdrawals (prior to age 59½).

Coverage

Public plans may offer general coverage for all types of employees, but benefit formulas and other plan provisions in state and local retirement programs are sometimes different for certain categories of employees (i.e., general employees, teachers, firefighters, police officers, judges, legislators, and elected officials). Such differences may result from historical distinctions or varying retirement policies. This is shown in table 2, where, for example, public school teachers typically have plans different from those for general employees.[42] Firefighters and police officers are typically permitted to retire with full benefits at a younger age than most other employees since these jobs typically require young and vigorous employees and entail a higher level of physical risk. Since the careers of legislators and elected officials may encompass a much shorter period of time than those of other categories of employees, plan provisions for these occupations may allow benefits to accrue at a faster rate.

Employee Contributions

Another key difference between public- and private-sector plans is the requirement in many public-sector DB plans that employees contribute toward the cost of the plan. In addition, it is rare that the employer matches the worker's contribution in public-sector DC plans, although this appears to be changing in recent years. Given the growth of 401(k) plans in the private sector, competitive pressures in the labor market seem to be prompting state and local employers to offer comparable plans. At least 10 states (Colorado, Delaware, Indiana, Iowa, Minnesota, Mississippi, Missouri, Maryland, Oklahoma, and Virginia) have followed the lead of private employers in the 401(k) area by encouraging 457 plan participation through the establishment of matching programs of their own, while at least another three states (Texas, Washington, and Wisconsin) have employer match plans under consideration.

Traditionally, 457 plans have been used by public employers to enable their workers to make pretax contributions to a retirement plan. One explanation for the modest participation rates associated with these plans is that public employees who participate in primary DB plans tend to view their 457 plans as providing only supplementary retirement income. Since employer contributions to a 457 plan add tax complexity and may lower allowable employee contribution levels, states are setting up parallel qualified 401(a) programs to hold the matching funds.[43]

[41] *If participation in a 403(b) plan is entirely voluntary, then it is not subject to Title 1 of ERISA.*

[42] *The system for teachers often preceded that for general employees.*

[43] *A 401(a) account for each employee can accept employer contributions while maintaining the structure of an individual account that belongs to the employee. Because employer contributions to a 401(a) do not apply to the employee's 457 contribution limits, they don't prevent participants from contributing the maximum allowable amount into a 457 plan (Jasien, 1999). In addition, 401(a) accounts give participants a vehicle that can accept 401(k) rollovers as well as provide for other flexible provisions such as loans. A further stimulus to employee participation in 457 plans should result from a new IRS guideline (Revenue Ruling 2000-33, July 2000) that permits sponsors of 457 plans to add an automatic enrollment feature to such plans. With passage of the Economic Growth and Tax Relief Reconciliation Act of 2001, Congress made 457 plans more attractive by expanding rollover features.*

Portability

Portability stems from two aspects of government retirement plans:

- First, there is the ability to purchase service credit from a new employer in a DB plan based on prior time spent with another public-sector employer or a private-sector employer, including a private or parochial school—either in-state or out-of-state. This is fairly common among state and local jurisdictions, but is not found in the private sector. This procedure typically allows employees to move more easily among public-sector employers without losing as much of their eligibility over their entire working history.
- Second, there is the ability of rolling over assets from deferred compensation arrangements—401(k) plans, 457 plans, and 403(b) plans—to individual employee accounts when moving among employers. This option has been expanded with changes in the law due to passage of the 2001 tax law (see Appendix).

COLA Provisions

Another difference between private- and public-sector retirement systems is the prevalence of cost-of-living adjustments (COLAs), which are common in most public plans but rare in private plans. Regular yearly increases are usually fixed at some percentage or may be tied to an index like the CPI. Ad hoc increases occur when system finances can afford the expense. As mentioned elsewhere, nearly all state-level plans offer COLAs either on an automatic or ad hoc basis, while less than half of private plans offer such benefits (Mitchell et al., 2001).

Governance & Funding

Retirement systems at the state and local levels are funded through a combination of tax revenues, employee contributions, and investment income. They are often subject to an extraordinary amount of oversight by the executive and legislative branches of government. This section briefly discusses major topics in the areas of funding and governance.

Administration

In general, a board of trustees, comprised of individuals from diverse backgrounds, establishes overall policy for administering state and local pension plans. The board may include representatives from the following groups: employees, retirees, employers, government, and individuals with particular skills (e.g., investment expertise). Board members make policy decisions within the framework of the system's enabling statutes that include: adopting actuarial assumptions (DB plans), establishing procedures for financial control and reporting, and setting investment policy (Public Pension Coordinating Council, 2000). Daily operations are typically directed by a chief administrative officer, who oversees a staff that varies in size relative to system size and demands.

Obligations, Liabilities, and Plan Funding

A majority of state and local retirement systems are supported by both employer and employee contributions. Employee contributions provide a steady source of income to public employee retirement systems. Contributions of public-sector employers are subject to the approval of the legislature (or other financing agency) and usually come out of general revenues. Employer contributions can also come from special taxes or levies.

As a normal part of the reserve funding process, retirement plans accumulate substantial obligations over time. Such liabilities must be offset by comparable assets to avoid future financing problems. The most common method to determine a plan's funding adequacy is to examine its funding ratio: assets divided by liabilities. There are different kinds of funding ratios, depending on the liabilities being measured and the period of reference. Most state and local retirement plans provide in

Table 13

Financial Assets[a] of Private and Public Employment-Based Retirement Plans, Selected Years, 1950–1998

	1950	1960	1970	1980	1990	1991	1992	1993	1994	1996	1997	1998
						($ in billions)						
All Funds and Reserves	$25	$91	$241	$902	$3,383	$3,807	$4,137	$4,549	$4,809	$6,274	$7,793	$8,989
Private Funds[b]	13	57	153	628	2,208	2,494	2,654	2,933	3,134	4,026	4,983	5,740
Private trusteed funds	7	38	112	470	1,572	1,861	1,959	2,194	2,352	3,155	3,706	4,331
Private insured reserves	6	19	41	158	636	678	695	739	782	871	1,277	1,409
Public Funds	12	34	88	274	1,175	1,313	1,483	1,616	1,675	2,248	2,810	3,249
State and local government	5	20	60	197	920	1,032	1,168	1,256	1,294	1,790	2,308	2,698
Federal civilian	4	10	23	74	246	272	305	349	370	446	488	536
Railroad	3	4	5	3	9	9	10	11	11	12	14	15
						(percentages)						
All Funds and Reserves	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Private Funds[b]	52.0	62.6	63.5	69.6	65.3	65.5	64.2	64.5	65.2	64.2	63.9	63.9
Private trusteed funds	28.0	41.8	46.5	52.1	46.5	48.9	47.4	48.2	48.9	50.3	47.6	48.2
Private insured reserves	24.0	20.9	17.0	17.5	18.8	17.8	16.8	16.2	16.3	13.9	16.4	15.7
Public Funds	48.0	37.4	36.5	30.4	34.7	34.5	35.8	35.5	34.8	35.8	36.1	36.1
State and local government	20.0	22.0	24.9	21.8	27.2	27.1	28.2	27.6	26.9	28.5	29.6	30.0
Federal civilian	16.0	11.0	8.2	6.8	7.3	7.1	7.4	7.7	7.7	7.1	6.3	6.0
Railroad	12.0	4.4	2.1	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2

Source: Employee Benefit Research Institute, *Pension Investment Report, Second Quarter 2000* (Washington, DC: Employee Benefit Research Institute, 2000); U.S. Office of Personnel Management, Retirement and Insurance Service, *Civil Service Retirement and Disability Fund Report for the Year Ended September 30, 1998* (Washington, DC: U.S. Office of Personnel Management, 1999); and unpublished data from the Federal Retirement Thrift Investment Board www.tsp.gov/forms/otherf.html and www.rrb.gov/statsindex.html#thru%202000

[a] Includes only those assets included within Federal Reserve Board's Flow of Funds accounts. The Flow of Funds accounts are restricted to only certain "financial assets" and therefore exclude such assets as real estate, physical property, and receivables. All nonequity holdings are estimated at book value. Short-term government bonds and all bonds with long-term original date-to-maturity are classified as bonds. Mutual funds are classified as other assets. Includes defined benefit and defined contribution assets.

[b] Does not include individual retirement accounts (IRAs).

their periodic audit reports a figure called the actuarial accrued liability (AAL). Because public-sector plan sponsors have differed in their application of this methodology, the Government Accounting Standards Board (GASB) in 1987 required pension plans to begin reporting liability figures using a standardized actuarial computation called the projected benefit obligation (PBO). This measures plan obligations for employees' service rendered to date and the projected salaries at retirement. Today, most public-sector pension systems report the PBO measure.

To be "actuarially sound," an employer's annual contributions need to meet the expected benefit accrual resulting from its annual operations in addition to amortizing the past unfunded pension liability (Mitchell and Smith, 1994). In practice, however, state and local plan administrators still maintain broad discretion in terms of the assumptions they use for salary growth rates, investment rates of return, worker turnover, and mortality patterns (Hustead, 2001). In 1994, GASB issued guidelines for funding policy in government plans (1996 implementation date) in the form of GASB Statement No. 25. Since that time, many plan administrators have been reluctant to adopt funding levels less than the amount required under the GASB No. 25 guidelines. Their reaction, coupled with the sizable gains obtained in the financial markets during the 1980s and 1990s, enabled some plans to reduce their contributions in recent years.

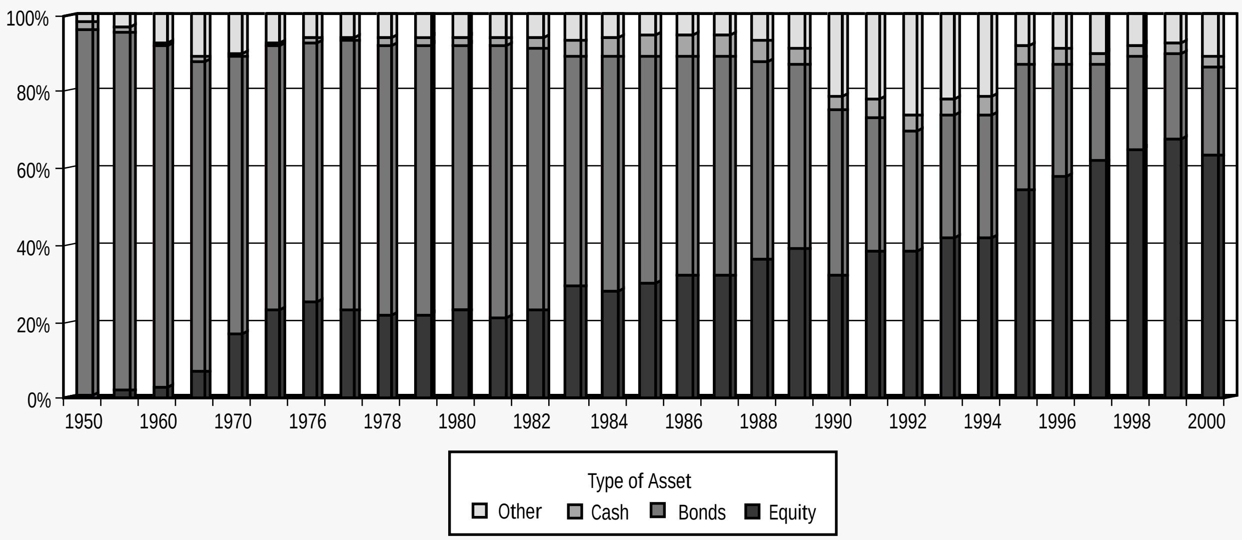
Governance and Investment Policy

To reduce the need for additional contributions to fund retirement benefits, state and local employee retirement systems earn supplemental income by investing the funds collected. Investments are made within a framework of state and local laws that regulate investment decisions. This framework has not prevented state and local funds from achieving good returns over time. The data in table 13 show that state and local funds increased their already substantial share of total (private and public) pension fund financial assets, not only among public-sector entities, but relative to other major investor categories in recent decades, rising from 20 percent in 1950 to 30 percent by 1998, or nearly $2.7 trillion.

Much of the asset growth in state and local pension funds can be traced to changes in portfolio management two decades earlier. This began around 1980 with the lifting of constitutional restrictions—

Chart 4

Annual Asset Allocation of State and Local Government Pension Funds as a Percentage of Total Assets, 1950–2000



Source: Employee Benefit Research Institute tabulations based on *Pension Investment Report*, various years (Washington, DC: Employee Benefit Research Institute).

designed to promote conservative portfolios—in many jurisdictions. Prior to 1980, most public-sector pension funds were invested almost exclusively in bonds. State legislatures often limited how much state and local plans could invest in certain types of investments (e.g., percentage of the portfolio invested in equities). This took the form of legal lists, which specified the range of financial instruments available to the plan and their corresponding percentage limits. Local pension plans have utilized legal lists to a greater extent than plans operating statewide (Harris, 1998a). 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). A related issue is the active encouragement of certain types of plan investments within the same jurisdiction as the retirement system. Anticipated benefits from such economically targeted investments (ETIs) include job creation, infrastructure, and the like.[44] Because investments by state and local plans remain subject to prudent fiduciary standards, ETIs are still expected to yield a competitive return for the level of risk involved (Harris, 1998a).

During the 1980s, public-sector pension funds modified their investment portfolios to include 40 percent to 50 percent investment in bonds and other fixed-income securities, with the rest in equities, real estate, and even venture capital. At the same time, public-sector administrators continued using relatively conservative actuarial assumptions, which contributed to higher levels of capital accumulation (Davidson and Pongracz, 1992). Chart 4 indicates graphically how the portfolio mix has changed for state and local funds. Evident in this chart is the preponderance of low-risk investments, chiefly bonds, from 1950 until the 1980s. After 1980, the share of bonds in state and local plan portfolios fell below 70 percent and continued to decline thereafter, while equities were included in balanced portfolios. In the late 1990s, equities comprised about two-thirds of state and local plan portfolios, while bond holdings were less than 25 percent. This rebalancing of portfolios, combined with high stock market returns and low inflation over the past two decades, produced some plans that are fully funded—a dramatic change from the situation of two decades earlier (Milliman & Robertson, 2000).[45] More recently, states and local funds have begun to concern themselves more closely with the companies in which they invest. Such investor activism can be viewed as another strategy by pension trustees to ensure that plans enjoy higher returns for the associated risks (Useem and Hess, 1999). These and other investment strategies (e.g., use of index funds) have had beneficial results.

[44] *See Harris for more detail (Harris, 1998a). Moore reports that 21 state systems have been given specific statutory language to pursue ETIs, but points out that statutory language is not always needed for ETI investment. They are often considered prudent under the general investment authority of many jurisdictions (Moore, 2000).*

[45] *These data include both DB and DC plan assets.*

Table 14
Surveyed State and Local Plans' Projected Benefit Obligation (PBO) as a Percentage of Assets and Distribution of Respondents by Funding Ratio, Selected Years, 1990–1998

	Mean PBO Funding Ratio Weighted by Plan Assets	PBO Funding Ratios					Number of Responding Plans
		<25.99%	25%– 49.99%	50%– 74.99%	75%– 99.99%	100%+	
		(percentage of retirement systems)					
1990	85%	2%	6%	21%	39%	32%	189
1991	88	1	5	22	38	33	221
1992	85	2	5	21	36	36	340
1995	93	4	5	17	37	37	362
1996	90	2	2	18	51	27	316
1998	98	1	3	11	39	46	299

Source: Employee Benefit Research Institute tabulations from the 1991, 1992, 1993, 1995, 1997, and 2000 PENDAT Database (Chicago, IL: Public Pension Coordinating Council, 1991, 1993, 1994, 1996, 1997, and 2000); and U.S. General Accounting Office, *Underfunded State and Local Pension Plans*, GAO/HRD-93-9R (Washington, DC: U.S. General Accounting Office, 1992).

Funding Status

A consequence of the steady increase in state and local plan assets is that funding ratios have improved in recent years, reflecting a long-term trend noticeable as early as the 1970s (Zorn, 1997).[46] Table 14 shows this improvement of PBO funding ratios in the 1990s from a survey conducted by the Public Pension Coordinating Council (Public Pension Coordinating Council, 2000). Since 1990, the percentage share of retirement systems with PBO funding ratios below 75 percent has declined steadily. Interestingly, the share of state and local plans in the sample with ratios above 100 percent has grown. This is also evident for the mean PBO calculated on an asset-weighted basis: rising from 85 percent (1990) to 98 percent (1998).

State and Local Trends

In recent years, benefit managers at the state and local level have looked carefully at prevailing practices in the business community as guides for many aspects of worker compensation (including pensions). But they have also begun to develop their own style of retirement benefits compensation geared to public-sector work force requirements. Due to the political and legal environments in which changes are considered, modifications to public-sector retirement programs have tended to occur later than in the private sector and have been more incremental. The frequency of systemic changes increased in the late 1990s, with both supplemental and primary DC plans being introduced in response to budgetary pressures, economic conditions, the political climate, and private-sector retirement plan developments.

A 1999 General Accounting Office report on changing benefit designs in statewide systems found an extensive range of options under consideration (U.S. GAO, 1999). These included one or more of the following: Replacing an existing defined benefit plan with a defined contribution plan, adding a DC component to the existing DB plan, providing an employer match to an existing employee contribution to a voluntary DC plan, and adding Social Security coverage.

In states not taking action, but where officials had considered terminating their DB plan in favor of a DC plan plus adding Social Security coverage, the major factors included potential cost reduction, enhancing portability for workers, and/or lobbying efforts by special interests. The most common arguments against the move to a DC-only plan expressed by state officials included the need for further study, opposition from organized labor, and a general lack of interest or support for the change. Most states that did not consider dropping the defined benefit component of their programs offered one or more of the following reasons: the DB plan provided relatively greater benefits (including disability and

[46] The turnabout is quite dramatic from the situation even a decade earlier, when a 1992 GAO assessment of the pension-funding practices of state and local governments cited their failure to make appropriate contributions to pension plans, the changing of actuarial assumptions or funding methods to lower employer contributions, and the use of pension funds to pay government operating expenses. It concluded that many state and local pension plans remained underfunded (U.S. General Accounting Office, 1992).

survivor benefits), DB plans were viewed as a more attractive tool to retain employees, and there was little or no support for the change.

Innovations in State and Local Plan Practices

Much of the variety and pace of change taking place in state and local retirement plans is occurring at the state level (see table 15).[47] It is interesting to note the timing of these changes: After West Virginia in 1991, no state took action to modify its benefit design until 1995–1996, when four states (Washington, Colorado, California, and Michigan) enacted benefits legislation. Three of these states utilized DC plans in a hybrid or a cash balance format. Among these four states, Michigan is unique in replacing its DB plan with a DC plan only for new hires. By 1998, as more states began to change their systems, a recognizable pattern can be seen taking shape, with DC plans increasingly used as a supplement (enhanced by employer matches)—and sometimes as an alternative to—a pre-existing DB plan. This pattern still holds through 2000, although the alternative DC plans enacted in North Dakota (1999) and Florida (scheduled for implementation 2002) signal that states are considering this alternative.

Overall, employee choice is often mentioned as a major reason not only for introducing DC plans but also for retaining them—either as the primary component or as a significant component of the overall package. In this way, states have addressed concerns about retaining current employees while attracting the talent needed for the work force of the future. A major added factor has been the exceptional stock market performance of the late-1990s, which significantly reduced pension fund liability ratios in most states and increased the attractiveness of DC plans among public employers, legislatures, and rank-and-file union members.

There also have been many types of incremental changes to existing (chiefly DB) plans in recent years.[48] When examined by topic, the types of minor changes reveal what states are focusing on: In 2000, legislative changes in state-administered systems took place in service credit/purchase of service to enhance portability (11 states); contribution rates and general DB provisions (10 states); funding issues (five states); formula annuity factors and vesting requirement changes (four states); taxation and governance issues (three states); and deferred compensation matches, early retirement incentives, and contribution withdrawals (two states).

Retirement topics studied in 2000 include actuarial computation methods (Arizona), benefit calculation rate (Delaware), examining ways to increase portability within state systems (Iowa), early retirement incentives (Kansas), employer match for 457 plans (Kansas), new DC option plans (Kansas, Montana), governance (Kansas), benefit adequacy (Nebraska), better recruitment of teachers (New Mexico), and general equity issues (South Dakota).

Some retirement issues of particular interest to public-sector plans include:

Gain Sharing—The term “gain sharing” is not applied universally, but in public-sector compensation it refers to ways in which employee groups are rewarded financially for improved performance (Segal Company, 1997). An expanded definition has spread to the area of retirement benefits and refers to the practice of providing excess monies from overfunded pension plans to participating employees and retirees in a retirement system.[49] At the state level in the 1990s, investment returns far above actuarial assumptions pushed state retirement funds toward full funding in most cases.[50] Improved funding levels provided plan sponsors with options for dispensing

[47] *Thanks to the staff at Colorado Public Employee Retirement Association for their suggestions on this table and general comments on current trends.*

[48] *Based on data obtained from the annual National Conference of State Legislatures report for 2000.*

[49] *Both definitions reflect profit-sharing practiced in the private sector.*

[50] *Comments by Ron Snell at a December 1998 Fiscal Affairs Committee Session of the National Conference of State Legislatures.*

Table 15

Significant Statewide Retirement Plan Changes Since 1990

State and Year of Change	Description of Change
West Virginia (1991)	Closed teachers' defined benefit (DB) plan to new hires and created a defined contribution (DC) plan because of the underfunded DB plan.
Washington (1995)	Created a third retirement plan (tier) for members of Teachers Retirement System, consisting of a hybrid (combined DB and DC) with employer funding the DB portion and the employee funding the DC portion.
Colorado (1995)	Changed PERA DB plan to provide a matching amount on refunds of member contribution accounts and create a money purchase retirement benefit.
California (1996)	State teachers retirement system (CalSTRS) adopted a cash balance plan for part-time and temporary employees.
Michigan (1996)	Replaced the DB plan with a DC plan for both state employees (SERS) and public school employees (PSERS) hired after March 31, 1997, but membership for PSERS members was later repealed; conversion of previous employee balances permitted under certain circumstances; in 1995, initiated a DC plan for participating local governments in the municipal retirement system. Legislation proposed in 2001 would allow all state employees to choose between SERS' DB or DC plan.
Maine (1998)	Extended eligibility for its DC plan for higher education personnel to new employees of the Technical College System.
Illinois (1998)	Created a DC plan and hybrid alternative plans for members of the State Universities Retirement System, a DB plan.
Vermont (1998)	Created an optional DC plan for new hires and then-current employees choosing to join at that time, because it was felt that the new plan would assist in the hiring and retention of talented workers.
Ohio (1998)	Created an alternative retirement DC plan for new education employees and for existing employees with less than 5 years' service.
Iowa (1998)	Law allows supplemental accounts to be established for active employees when the Public Employees Retirement System (PERS) system becomes fully funded; accounts will be provided through employee contributions as dollar credits after the system's unfunded actuarial liability (UAL) equals zero; amounts credited will equal the difference between contributions paid and the retirement system's normal cost.
Virginia (1998)	Allowed very large school districts to offer a DC retirement plan to superintendents.
Colorado (1999)	Increased the matching amount used to calculate money purchase retirement benefit; increased the matching amount on member contribution account refunds; law permits a match on member voluntary DC plan contributions (401(k), 457, 403(b), 401(a)) when Colorado PERA is fully funded; this allows statewide elected officials, legislators, staff of the governor, and legislative staff to choose DC plan in lieu of the existing DB plan.
North Dakota (1999)	Created a DC plan for elected and appointed officials and non-classified state employees; the predominant DB plan was modified to include (1) an employee 457 match (401(a) account) to encourage participation and (2) allow departing employees to receive both employer and employee contributions to make the DB plan more portable.
Montana (1999)	Created an optional DC plan for PERS members effective in 2002; PERS includes state, municipal, and school district employees other than teachers.
Idaho (1999)	Law enacted (effective 2000) creates gain sharing plan benefiting active employees, beneficiaries, and the employer; employees with a minimum 12 months' active service are eligible based on DB plan account balance and can direct the additional account investments from gains; beneficiaries receive (as available) any gains in a lump sum each January in proportion to their current benefits; employers can credit any gains toward their future contribution obligations. Gains equal excess investment returns beyond the amount required for actuarial liabilities plus rate stabilization reserve.
Missouri (1999)	Replaced the existing DB plan for state employees and law enforcement officials with another DB plan that does not provide a separate benefit schedule for law enforcement.
Arizona (1999)	Created an optional DC plan for exempt state employees and elected state officials subject to term limits; also created a 401(a) plan for term-limited officials and legislative staff members.
Louisiana (1999)	Extended eligibility for its Optional Retirement Plan for academic and administrative personnel in higher education to employees of governing boards.
South Carolina (2000)	Created an optional DC plan for teachers and school administrators in the state's K-12 system that is open only to new hires.
Utah (2000)	Allowed legislators to choose to join the existing DC plan for elected officials instead of the regular DB legislators' retirement plan.
Ohio (2000)	Created an optional DC plan for the state teachers system (STRS); contributions will be same as for the DB plan.
California (2000)	Created the DB Supplemental Program for all STRS members; a tax-deferred account is set up for each teacher.
Florida (2000)	Created an optional DC plan (effective June 2002) for all state and local government employees, teachers, and school employees; it will allow current and new public employees a one-time option to switch between the DB and the new 401(a) DC plan; the new plan encourages individual investment retirement and is 100% funded by the employer at the same rate as the co-existing DB plan; a key consideration in taking this step was to increase the public employers' ability to compete with private sector in attracting and retaining workers.
Washington (2000)	Created a mandatory retirement plan for employees of state agencies, higher education, and local governments consisting of DB and DC portions; employers contributions fund the DB portion while employee contributions fund the DC portion; the arrangement is similar to one created for teachers in 1995.

Sources: Changes to state and local retirement systems tracked by EBRI staff from media reports and EBRI Member referrals.

the excess. These options have allowed states to increase their funding of existing DC plans (Idaho), raise benefits (Washington), amortize the existing unfunded liability and even discontinue employee contributions (Idaho). Iowa is using its surplus to provide a COLA and distribute funds to supplemental accounts of active members pending elimination of the unfunded liability.

Enhanced Flexibility in Retirement Planning—There are two recent important trends on the state level:

- A Deferred Retirement Option Plan (DROP) is a provision included in a DB plan that allows long-term employees to eventually leave their job with both a traditional annuity and a lump-sum amount as in a DC plan. An employee electing to participate in a DROP will continue to work for the employer but cease to accumulate further credits toward retirement—the future DB annuity is thus frozen at enrollment—in exchange for credits placed by the employer into a personal retirement account. DROP account balances are then managed as part of the DB plan total portfolio. When the employee departs, both the DROP contributions and the annuity are received as a retirement benefit. These plans originated chiefly in local public safety pension plans, where members could retire with full benefits at an early age. Employers realized the benefit of retaining a valued employee versus the expense and disruption of recruiting and training an inexperienced one. Use of the DROP also enabled public-sector employers to predict with greater accuracy future employment needs (Perdue, 2000). The use of DROPs at the state level is growing, and in 2000 legislation regarding DROP plans was enacted in four states.
- Re-employment after retirement is another way to maintain the size of the work force. Seven states took legislative action to increase opportunities for re-employment after retirement. Most cases involved teachers.

New Payment Options (combined annuity and partial lump-sum distributions)—In 2000, California replaced the DROP plan in the CalSTRS defined benefit plan with an option for retirees to select a lump-sum payment and a reduced annuity at the time of retirement. Newly enacted provisions in Mississippi and Kansas also allow for partial lump-sum payments from the DB plan.

Conclusions

State and local retirement plans share many issues with private-sector plans, but have preserved their own character. As these plans become more influenced by federal legislation and regulation, implement more defined contribution plans into their retirement systems, and continue to operate like private-sector entities on the investment front, the differences that set them apart will become less noticeable. All of these possible changes will bring new choices to plan administrators and employees alike. Areas where some movement toward a narrowing or widening of differences between private- and public-sector retirement plans may include:

- *Social Security coverage and the public sector*. The dividing line between systems that choose to remain inside or outside the Social Security system is fairly clear-cut. Discussions of reform will inevitably involve whether or not to mandate coverage for all workers. Such changes involve equity and cost issues. Proponents note that mandating coverage will enhance retirement asset portability for state and local workers, provide full inflation-adjusted benefits, and, in the short run, help with the solvency problem facing the system (Munnell, 2000). Critics, including some participants in retirement systems and government plan sponsors outside Social Security, tend to view participation in Social Security as burdensome (Segal Company, 1999), arguing that job categories are often unique to the public sector (public safety, judges, legislators, etc.). It is felt that retirement systems designed and funded to address such special needs would be undermined by universal requirements. In addition, mandatory coverage would be expected to increase the cost to employers and reduce current benefit levels, and therefore threaten future benefit levels. Higher required contribution levels would make it more costly for employers and less generous to new hires, many of whom would be forced into another plan tier for Social Security. Reduced benefits can also be expected from older retirement ages in the coming years.

- *Flexibility in plan design*. The number and variety of multi-tiered systems created in recent decades can be expected to expand with passage of the Economic Growth and Tax Relief Reconciliation Act of 2001. The attractiveness of DC plans in the private sector has now been recognized by plan sponsors in the public sector—both as primary and supplemental plans—who see them as vehicles to improve benefits while reducing their exposure to future investment risk. Newly enhanced portability features of 403(b) plans, 457 plans, and 401(k) plans factor into this calculation, offering both employer and employee alike more choice. At the same time, improved portability features of DB plans are likely to encourage their dominance in the public sector, with new tiers likely to be supported by improved DC supplements.

- *Benefits in general*. In recent years there has been a distinct improvement in public-sector benefit formulas for large statewide plans, according to a National Association of State Retirement Administrators (NASRA) report (NASRA, 2001). In other areas, faster vesting is likely for public-sector workers, if public employers are to compete with private-sector employers in attracting and retaining skilled workers. A trend toward the five-year cliff vesting ERISA standard was detected in a 1996 survey of major public employee retirement systems (State of Wisconsin, 1996), and the move to DC plans will encourage further movement in this direction. COLAs are relatively common in state and local plans, and changes since 1998—although varied in scope—appear to indicate a trend toward more generous calculation methods (NASRA, 2001).

- *Fund governance and asset management*. Funding of state and local retirement plans has improved greatly over the last 30 years, and fund performance of some larger public-sector funds has been competitive with private-sector funds. Elimination of the remaining investment restrictions (legal lists) and widespread use of modern portfolio management techniques should continue. The increased use of DC plans—either as a supplement or primary plan—will mean increased choices for employer and employee.

Appendix Effect of the Economic Growth and Tax Relief Reconciliation Act of 2001 on State and Local Pension Plans

On June 7, 2001, President Bush signed into law H.R. 1836, the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), which reduces federal taxes by an estimated $1.35 trillion over 10 years. Title VI of the bill addresses pension and retirement plan provisions, which are estimated to cost about $49.6 billion over the next 10 years.

Provisions of the law that relate to public-sector retirement plans include the following:

Increasing Portability for Participants:

- Purchase of service credits under governmental retirement plans. Beginning in 2002, permits the use of Sec. 403(b) and Sec. 457 assets to purchase service credits in public-sector DB plans by allowing the transfer of funds (direct trustee-to-trustee exchange) to a governmental DB plan.

- Rollovers of retirement plan and IRA distributions. Starting in 2002, eases restrictions for eligible rollover distributions (but only through a direct rollover) among qualified retirement plans, Sec. 403(b) annuities, IRAs, and governmental Sec. 457 plans, including rollover of after-tax amounts; surviving spouses would be able to roll over distributions to a qualified plan, 403(b) annuity, or 457 plan in which the spouse participates.

- "Same desk rule." Repeals "same desk rule" for 401(k), 403(b), and 457(b) plans by replacing "separation from service" in Sec. 401(k)(2)(B) with "severance from employment"; employees would be allowed to roll over their accounts in their prior employer's plan to their new employer's plan or to an IRA.

- Waiver of 60-day deadline. Beginning in 2002, the IRS may waive the 60-day deadline for rollovers under hardship circumstances.

Contribution and Benefit Limits:

- Elective deferral limits for 401(k) plans, 403(b) annuities, and 457 plans. 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; indexed for inflation thereafter.

- Compensation-based DC plan limits. Increases the dollar limit on annual additions under Sec. 415(c) from $35,000 to $40,000, then indexes in $1,000 increments; also increases the 25 percent of compensation limit on DC plans to 100 percent.

- Compensation-based DB plan limits. Increases the Sec. 415(b) DB dollar limits from $140,000 to $160,000 at age 62, with late-retirement adjustments for benefits starting after age 65; then indexed in $5,000 increments.

- Catch-up contributions. Allows catch-up contributions to 401(k), 403(b), and governmental 457 plans for participants 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; indexed thereafter.

- 401(a)(17) DB compensation limit. Increases the 401(a)(17) DB compensation limit to $200,000 from $170,000, and indexes thereafter in $5,000 increments.

- Maximum exclusion allowance for 403(b) plans. Repeals the 403(b) exclusion allowance applicable to contributions to Sec. 403(b) annuities; therefore, such annuities are subject to the limits applicable to tax-qualified plans.

- Limits on deferrals under 457 plans. Increases the 33-1/3 percent of compensation limits on deferrals under 457 plans to 100 percent.

- 457 plan coordination requirements. Repeals the coordination of Secs. 415 and 457 limits.

IRA Changes:

- Changes to IRA contributions limit. Annual IRA contribution limits increase from the current $2,000 limit to $3,000 by 2002, to $4,000 in 2005, and higher in future years.

- IRA contributions. Beginning in 2003, 401(k) and 457(b) plans will be allowed to permit employee contributions to separate accounts or annuities and to elect to treat the contributions as IRAs or Roth IRAs.

- Roth IRA contributions. 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:

- Tax credits for low- to moderate-income individuals. Provides a federal income tax credit to match part of the salary-reduction contribution of individuals with incomes below $50,000 who participate in 401(k), 403(b), or governmental 457 plans, or to IRAs, of up to $2,000 annually, with the size of the credit declining from 50 percent to 10 percent as income increases.

- Clarification of tax treatment of 457 plan assets in divorce. Applies the tax rules for qualified plan distributions, according to a QDRO order, 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.

- Retirement planning services. Retirement planning services generally provided to employees by an employer maintaining a qualified employer plan are excluded from the employee's gross income for tax purposes.

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