Public Money

Bargaining for Benefits Reform

It's time to take a harder line on under-priced "bennies." Here's how.

By Girard Miller | July 9, 2009

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With their backs up against the wall, state and local government managers and labor negotiators are finally waking up and smelling the putrid coffee they've brewed in their retirement plans. Many cannot afford to make next year's actuarial payments, and the harsh reality is that most will never be able to fund them properly when the actuaries recalculate the bills to account for recent investment losses. The New York State controller just issued a report projecting that local pension contributions must triple to 30 to 40 percent of payroll. Yet elected officials and union officials continue to act like this problem will somehow be magically solved by their successors, so why should they bother to make sacrifices? After all, nobody else before them ever did.

The path of least resistance across the country is to start the next round of labor negotiations with a pussyfoot approach: trimming a few benefits for new hires. After all, that is non-controversial. Why fight the resistance at the table? The union stewards who sign the deals are incumbent employees–these are their paychecks, pensions and retiree medical benefits.

It's time to for the professionals who sit on public employers' negotiating teams to press harder against what are now obviously unsustainable benefits and indefensible negotiating positions held by labor officials. This requires tough decisions and a commitment to make the inevitable changes that nobody wants to make.

Here's my step-by-step advice to labor negotiators:

1. **Start with a clear picture of the future**: There will be no money for salary increases for years to come, unless retirement benefits are right-sized to match the new economic reality. Actuaries can provide you with a chart of rising pension contributions and the actuarial curve of the doubling or tripling costs of pay-as-you-go retiree medical benefits.

   Given that you are now furloughing employees, cutting services and freezing salaries, ask labor leaders how they expect your tight budgets to pay them the same benefits going forward. They will then tell you that they base their position on promises you made them. You need to point out that your promise was to pay for retiree medical benefits up until today, and that we are now talking about the future, and they need to own up to the future. If they want to avoid pro-rata reductions in benefits because of insufficient funds when they are themselves retired, you must start an actuarially sound financing system with employee cost-sharing. Now.

   You should be prepared to present this data along with the employer contribution rates for retirement benefits to the media if an impasse results. Voters will not side with the union position when they see the graphic that shows the inevitable increase in your retiree medical bills and your ratio of employer to employee contributions in comparison to the local labor market data — information you can obtain from the regional personnel association.

2. **Introduce the new reality for new employees**. The easiest thing for labor leaders to do is to "sacrifice their unborn." They will usually take a deal to cut benefits for new employees before incumbent employees because future employees don't vote on the contract. It's really that simple.

So here are the non-negotiable starting points for reforming retirement benefits for new employees:

> **Retirement now begins at 67**. Social Security law now requires Americans born after 1960 to work until age 67 to receive unreduced pension benefits. New state and local government employees should be required to follow the same standard, or else take an actuarial reduction — just like Social Security. For workers born after 1960, an early retirement at age 62 under Social Security now requires a 30 percent reduction in benefits. When Social Security is ultimately reformed to achieve actuarial balance, the retirement age for today's college graduates will probably be 70, and the reduction factors will be even deeper. So an age 67 hurdle is completely reasonable, and will reduce your normal actuarial costs significantly five to 10 years down the road. It's also a necessary first step toward changing the age requirements for incumbents as explained below.
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> **Pension multipliers over 2.5 percent don't work**. A 3 percent pension multiplier is justified only for public employers that do not participate in Social Security (or 25-year full-career public safety retirees, payable once they attain age 62). For a 30-year employee, a 2.5 percent pension multiplier provides a pension of 75 percent of final salary. When you then add Social Security plus expected personal savings under the "three-legged stool of retirement security," this is a sufficient pension especially if inflation-indexed, as well designed public pension plans are these days. If your present

plan is more generous, re-instate a lower multiplier.

> **Retiree medical benefits must be capped and CPI indexed**. Today's new employees are grateful to have any retiree medical benefits, especially in light of private-sector practices which are heading toward nil. Put a dollar cap on new hires' retiree medical benefits equal to the current insurance cost for single retirees, and then let it escalate in dollar terms by the CPI. This will significantly reduce the actuarial cost for employers and employees.

> **Establish an annual employee accrual rate for retiree medical benefits**. As with a pension, the "other post-employment benefit" (OPEB) for retiree medical expenses should be calculated as an accrual formula. For example, each year of service earns 3 or 4 percent of the full dollar benefits under the plan. If an employee works 25 years under a 4 percent accrual system, she will accumulate a 100 percent benefit. Giving employees an incentive to earn more than 100 percent of the target benefit level by working longer than 25 years will actually reduce retirement costs in most cases, so I favor the 4 percent solution without a ceiling.

> **Require new employees to pay half**. The single most important labor agreement for state and local government bargainers to achieve is the equal cost-sharing of pension and retiree medical benefits. New hires are entering your workforce based on today's salary and benefits package, and in today's recessionary economy, new recruits are grateful to have that job. You should strike an entirely new labor deal with this generation, and then stick to your guns thereafter. If the new employees' payroll withholding is a large number, you can two-stage the pension contributions after the first salary adjustment date and retiree medical (OPEB) contributions on the second, or step them both up annually over three to four years as explained below (see #5).

You then need to address incumbent employees, who are the costliest sacred cows in labor relations today. We can't reduce benefits for retirees, which is the third rail of public pension plans, but there is no rational reason for public employers to shy away from the root cause of today's retirement plan deficits — the incumbent employees.

Under many states' laws, employers cannot reduce already-earned benefits for retirees and vested employees. However, there are only a few states that require a public employer to continue offering the same benefits package to incumbent employees for the future services they provide. Yet most governments don't try to reduce the prospective benefits formula for incumbent workers. To achieve significant immediate budget savings, however, you need to start with the incumbents, not the new hires.

So here are eight suggestions for benefits plan changes for incumbent employees:

> **Increase employee contributions for pensions and retiree medical plans**. Most public employees pay a small fraction of the cost of their pensions, usually about one-third or less. In the case of first responders, it's a much lower ratio, often 20 to 30 percent of the total cost of their pension plan's annual required contributions. In the private sector, few companies today pay more than a 100 percent employer match into a 401(k) plan. In the case of retiree medical plans, most private employers don't offer this benefit and public employers have failed to charge employees anything, because they have failed to establish GASB-qualified trust funds as explained in my previous column. Start with a 1-percent-of-salary increase in the employees' present share of the pension plan contributions, and a new 1-percent-of-salary employee share for the retiree medical plan. Then negotiate for these ratios to be increased each year until you achieve equal cost shares with the employer, just as you would for new employees, as mentioned above.

> **Put a dollar lid on retiree medical benefits**. As with new employees, it is actuarially essential that you put a cost cap on your "other post employment" (OPEB) benefits. Even a CPI indexed limit is better than an open-ended promise to pay whatever it costs in the future. Aside from requiring an employee contribution, nothing else will have as important a long-term impact on your OPEB plan costs. You can also limit the benefit to today's single-employees' premium level, as there is no objective rationale for taxpayers to bear the costs of dependent coverage after retirement.

> **Reduce the pension multiplier for future service**. This complicates the benefits calculation slightly, but if your pension plan provides a multiplier of more than 2.5 percent times years of service times final compensation, then you will derive major savings if you apply this lower number to future service. For example, a senior incumbent employee can be paid a pension for 20 years of past service at 3 percent and the final 8 years at 2.5 percent, for a total benefit of 80 percent of final salary, instead of 84 percent. This is actually the fairest way to introduce a formula reduction across the entire workforce, as older workers will retain their earned benefits, and future service is compensated at a lower rate that the employer can actually afford to sustain as part of a comprehensive reform. This precedent is important, as it undercuts the idea that the multiplier is permanent and only ratchets upward. Obviously, you should only change this formula once in a blue moon, as multiple earnings rates can become confusing and difficult to communicate.

> **Provide incumbent-transition features for plan changes**. One way to bridge a benefits plan change for incumbent employees is to allow vested workers to retire within five years under the former benefits plan. Thereafter, they become subject to the same benefits formula as other incumbent employees — subject to an ongoing requirement that the present value of the new benefits in dollar terms cannot be less than what they had earned up to the date of the plan changes.

This approach should satisfy the "fairness" test. If a workforce reduction is desired because of budget limitations, an alternate approach is to negotiate a shorter one-year transition window that encourages early retirements, to accompany the other long-term cost-reducing measures.

For retiree medical benefits, you can apply the annual service credit multiplier introduced above for new employees and credit incumbent employees with a minimum number of years under a "transition table." For example, a 15-year employee at age 55 might be granted 20 years of OPEB credits so that another five years of employment would be sufficient to earn full benefits, and there would then be an incentive to keep working beyond age 60.

Establish a "new normal" retirement age at the Social Security ages of 66 for older workers and age 67 for those born after 1960 with less than 30 years of service (lower for first responders), with actuarial reductions for earlier retirements. Along with the five-year transition rule explained above, this feature can achieve wonders in reducing pension and OPEB costs.

Establish individual, mandatory medical-savings accounts for retirees. If the union stonewalls a mandatory employee contribution to the OPEB plan, then you should at least require that employees start saving a percent or two of salary toward their retiree medical expenses through individual accounts. These can capture unused sick leave time as well and build a tax-free benefit for employees upon retirement. This feature works especially well when you establish a dollar cap on the OPEB benefit.

Provide for benefits restoration or supplemental employer contributions if revenues exceed your expectations. Union leaders will be skeptical of management's claims that there is no money. If you cry wolf, and then magically find new revenues in the future, you will lose all credibility at the bargaining table and, frankly, do your employees an injustice. So you should lead your discussions with a provision that if future recurring revenues exceed your projections, then salaries or employer contributions can increase or selected benefits cuts can be restored or employee contributions increases can be postponed. A "clawback" clause enables the labor negotiators to sell their members on the hope that eventually the economy will turn around faster than economists expect.

Price and pick the best ideas. My suggestions are intended to provide a menu of options to explore, so that negotiators can actually negotiate. Your actuary can give you some ballpark numbers and guidelines to help you understand the reductions in employer contributions that will result from various combinations, and those are worth obtaining before you start the negotiations. You will then be better equipped to explain the trade-offs to your elected officials as well as the opposing negotiators.

Related Terms: Business Controller Entertainment forward Health Management Pensions and Retirement Private Public Money Technology

COMMENTS

by **Bull (not verified)** | July 13, 2009

Civil Servamt pensions

Your suggestions are a good start, but DO NOT go far enough. The key comparison for benefit design should be what the private sector taxpayers (who pay for the vast majority of civil servants' pensions & benefits) get.

I do not believe you will find ANY private sector defined benefit plan paying even your reduced 2.5% of final pay per year of service. In fact I do not know of any paying more then 1.5%. This, ... 1.5% should be the bogey unless it can be shown that a higher rate is "typical" in the private sector.

Another undiscussed but MAJOR issue is the definition of fianl pay used in the benefit formula. In the private sector, it is typically a 3-5 year average of BASE PAY period, and that is the way it should be in the public sector. Civil Servant "pay" formulas often include everything including the notorious "kitchen sink", all to unfairly increase benefits. NONE of these should be included : .... overtime, uniform allowances, housing allowances,.... in fact, to stop the game playing the formula must proactively state the NOTHING but base pay is included, EVER.

Lastly, a year of service must be linked to 1000 MINIMUM of documented paid service in the year (just as it is in the private sector), not some minimal dollar amount that lets all the policicos gather service years, for a late career screwing of the taxpayers.

> by **Anonymous (not verified)** | July 13, 2009
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> ### Civil Pensions
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> The key component, my personal opinion, should not be what the private sector taxpayers get since what they receive as pay depends on where and for whom they work. It is generally recognized that private sector workers receive generally higher pay than public sector workers and because of that public sector worker

benefits are constructed with this key component in mind. In fact some private sector employees (my personal preference is "employee: as opposed to "worker") receive consideralby more than public sector wmployees.

The fact that many private sector employers are not obligated to contribute to their employee's 401k plans and are allowed to do so, should be the cause for alarm here, since the private sector is not carryin on with their responsibilities to their employees in many cases. Also, in some states public sector state employees have not had substantial raises over a period of several years. And, now, you are suggesting ways to lower their benefits.

State and local employees are not being furloughed because of benefits, but because of the recession that is touching them as well as private sector employees. A word about that recession.

If public sector employees going to be asked to receive less in benefits, in addition to their lower wages and salaries in general, then the solution here is maintain pay levels and enact new governmental polices that increase employment, even during a contraction, not continued "sacrifice" in the public sector. This situation can be resolved by making sure that the recent recovery money given to our financial power houses is indeed loaned to those struggling to stay in their home at affordable montly payments and that people in both the public and private sector, especially those at the lower income levels in both public and private sectors, are paid more to begin with, without the continural growth in disparities in income we see across our country. Otherwise, we will have another jobless recovery, despite all this talk of stimulus, since there will be little funds around to purchase those products and services needed to put everyone on the road to recovery without leaving more public and private sector wmployees without hope of employment and pensions.

by **Bull (not verified)** | July 13, 2009

Either you are uninformed, or

Either you are uninformed, or hpoing otheres do not realize it, but statistics (yes, by the us BLS) clearly indicate pay of gov'rt workers exceeds that of private sector workers. when the MUCH MUCH MUCH higher pensions & benefits of civil servants are factoreed in, the disparity gets much wider.

Do you not see waht is going on in CA, NY, NJ, OH, MI ? All are rapidly approaching bankruptcy, and the PRIMARY cause is overly generous pensions and benefits.

Of course, the workers are not to be blamed (who wouldn't take all they can get). The blame belongs with the greedy civil service unions and our self-serving, vote-selling, contribution-soliciting politicians (the "enablers"). It will be near impossible to fix this situstion until there are term limits everywhere, and politicians are excluded from ANY participation in pensions & benefits.