ORSC REPORT

The Ohio Retirement Study Commission — November 16, 1994

EARLY RETIREMENT INCENTIVE PLANS

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Introduction - At its meeting of June 8, 1994 the Ohio Retirement Study Commission requested that the staff prepare an informational report on early retirement incentive (ERI) plans in the public sector. Specifically, the staff was asked to provide the following information:

- Studies done by other states concerning the effects of ERI plans;
- Ohio's experience with ERI plans; and
- Identification of areas for further study.

This report is submitted pursuant to such request.

ERI Plans Generally - Traditionally, state and local governments have adopted ERI plans to cut payroll costs and reduce work force as an alternative to layoffs during difficult budgetary and economic times. Apart from financial reasons, some state and local governments have also used such plans to provide for greater managerial flexibility in restructuring operations, in making promotions, and in maintaining a balance in the age and composition of the work force (something that might not occur in seniority-based layoffs). Whether ERI plans are considered effective often depends on the purpose for adopting such plans in the first place.

ERI plans typically target a defined group of employees, usually those already eligible to retire or within a few years of retirement. An economic incentive is offered to employees who retire during a specified period, commonly known as a "window." Cost savings are realized by not filling the vacated positions, or filling the positions with employees at lower salary levels. According to a national survey conducted by the Texas Pension Review Board in 1992, eligibility requirements generally included only those employees who were within five years of normal retirement age or who were already eligible to retire. Also, the length of the "window" ranged from 30 days to ongoing, with the most common time periods being either 60 days or 90 days.

The economic incentives offered under ERI plans vary and can heavily influence the participation rate among eligible employees. Presented below is a list of various incentives offered by public employers across the country:

- Additional years to age and/or service;
- Lower age and/or service requirements;
- Lump sum cash payments;
- Reduction or elimination of early retirement penalties;
- Higher final average salary calculation;
- Periodic supplemental payments according to prescribed schedule;
- Continuation of health insurance coverage;
- Purchase of additional years of service by employee;

- Allowance of unused sick leave to qualify for retirement;
- Continuation of employment after retirement at reduced salary for limited period;
- Increase in benefit formula multiplier,
- Age and service combinations;
- Some combination of the above.

The Texas survey of ERI plans offered by 25 states in the five years preceding 1992 indicates that the use of additional service credit and/or reduction of retirement age remain the most prevalent methods of enhancing retirement benefits, although lump sum cash payments continue to be an option used quite frequently. Also, the continuation of health care coverage to the retiree and dependents has become an important issue as evidenced by a significant increase in its use in various incentive plans. A similar survey done by the National Association of State Budget Officers (NASBO) substantiates these findings. In that survey of 25 states that offered ERI plans in the five years preceding 1990, about half of the states offered a reduction in the age and service requirements for retirement and about half the states used an increase in service credit as an incentive, often in the range of a 5% to 10% increase.

According to the Texas survey, participation rates in various ERI plans offered by the states ranged from 6% to 61% of those eligible, with an average participation rate of approximately 30%. Of course, those incentive plans which offered the greatest enhancements at no cost or minimal cost to the employee had the highest participation rates. The NASBO survey found that on average 42% of eligible employees retired during the incentive period, ranging from a low of 22% to a high of 75%. Plan participation is perhaps the most difficult aspect to predict and control since it is never clear how individuals will react to such an emotional and financial decision as retirement. In any event, participation rates can be expected to vary depending on such factors as the value of the incentives offered, the perceived fear of lay-offs, prospects of further salary increases or promotional opportunities, current economic and work place conditions and individual health, financial and other personal reasons.

ERI plans have received mixed reviews. Advocates of such plans cite a number of reasons for their use. ERI plans can be useful in avoiding lay-offs, downsizing government operations, and achieving payroll savings. They can also provide a means to allow administrators more flexibility in managing their work force and promoting younger qualified employees.

On the contrary, opponents argue that cost savings are negligible or non-existent since in many cases the majority of the positions vacated under the ERI plan are filled, and therefore the plan becomes nothing more than an added retirement benefit. Another disadvantage cited by opponents is that the loss of experienced workers all at one time, sometimes referred to as "brain drain," results in increased training costs and administrative problems and adversely affects the effectiveness and efficiency of government operations. ERI plans are also viewed as unfair to members who retie before or after the window with similar age and service, yet lower benefits. Further, ERI plans can be used to shift costs from current state budgets to public pension funds, providing short-term personnel savings but creating significant long-term pension liabilities which must be paid by future generations. Once adopted, few states closely monitor such plans or perform any cost/benefit study or analysis after the window is closed, though the recent Texas survey indicates that states offering such plans are beginning to provide for improved accountability of the costs and savings incurred.

The degree of "success" of ERI plans can vary depending on the employer expectations. In this regard, the Texas survey concluded: "Many states felt that an early retirement incentive program was useful in meeting the initial stated goals of reducing work force, avoiding layoffs, and providing payroll savings. At the same time, most states indicated disappointment in the long- term reduction of employees and costs. It appears that in some cases the costs were considerably more than the savings, with the cost of incentives wiping out any financial gains. States which showed some cost savings were those whose enabling legislation either placed restrictions on the number of rehires or included provisions for the cost of the program to be borne by the employer with cost savings certified prior to implementation of the retirement incentive plan."

The NASBO survey reached a similar conclusion: "States indicated that a key element of a successful early retirement plan was to maintain position vacancies for an extended time period, such as three to five years. . . . Successful plans, in a budgetary sense, require discipline on the hiring side. Without such discipline and without a long-term focus, states could find themselves refilling the majority of positions after funding generous retirement incentives."

The National Education Association (NEA) had prepared by an actuarial firm a comprehensive report on ERI plans offered by states in order to provide public decision-makers with information about their implementation and possible impact on public pension funds. The report was released in 1994. As part of this report, a national survey was conducted of states that have offered some type of ERI plan within the last five years. The two most common reasons for offering incentive programs were cost savings and work force reduction. The survey found that the success rate for states which enacted the incentive programs was low (approximately 35%). The main reasons given for program failure were that fewer employees retired than anticipated and that the hidden costs associated with offering the program were higher than expected. Based on the results of such survey, the NEA emphasized the importance of performing a thorough analysis of the incentive plan and its possible impact before deciding whether to offer such plan. "Poorly designed programs and unanticipated acceptance/rejection rates can result in net costs rather than savings and can leave the local district with a shortage of quality employees."

Based on the Texas survey, NASBO survey, NEA survey and correspondence with several state administrators who have implemented ERI plans, there appear to be several essential requirements for a successful incentive plan. Perhaps the most important element in the design of an ERI plan is the need for clear objectives and goals. Financial objectives should be quantified and personnel objectives should be qualified in order to determine their potential effectiveness. Often times the financial "gains" from ERI plans are defined with short-term horizons and ignore the long-terms costs associated with increased retirement and health care obligations, thereby shifting costs away from the current operating budget to future retirement plan contributions. Also, financial goals are but one reason for the adoption of ERI plans, albeit the primary one for most states. Achieving personnel goals such as avoiding layoffs may warrant the offering of an ERI plan even if net costs would result.

There is also a need for extensive analysis and thorough planning &fore offering an ERI plan. Clarifying goals, defining the target group, determining effective incentives, fixing the duration of the window, estimating participation rates and providing effective controls over hiring replacements are all important elements of an ERI plan. Allocation of costs associated with the incentive program, including retirement, health care and administrative *expenses,* is another critical element, Such costs could be paid by each employer whose employees retire under the incentive plans. The payment could be made in a lump sum at the time of the window or over a limited period such as three to five years or over the public pension plan's amortization period. In the alternative, such costs could be added to the pension plan's unfunded liability, requiring all employers to fund the increase benefit costs associated with the incentive plan. Careful consideration should be given to the plan's funded status when costs are absorbed by the plan. In the case of pension plans with marginal funding, such costs will most likely be borne by future taxpayers, and may threaten the benefit security of current retirees as well as preclude benefit improvements for future retirees. In addition, it is important to have in place an administrative apparatus to insure clear employee and retiree communications, rapid benefit estimates, smooth application processing and pre-retirement counseling.

It is necessary for states to monitor ERI plans closely, with particular emphasis on record-keeping regarding costs, savings and participation. Provisions should also be made for a cost study or analysis after the window is closed. Explicit accounting for all costs, including future costs to retirement systems, is essential to evaluate the effectiveness of the incentive program as ERI plans are often used in the public sector as short-term solutions to problems, with little consideration being given to the long-term fiscal integrity of the pension plan.

Another key element is the effective-targeting of positions in each agency for participation in the incentive program. ERI plans are often too broad-based, offering the incentives to all eligible employees without regard to whether their jobs are essential. States may find that many of the departing employees are needed and soon replace (or contract with) them, incurring payroll and benefit costs they had anticipated saving while paying additional retirement costs for those who had just left. While an ERI plan with adequate and appropriate incentives can reduce salary costs, tight control over the hiring of replacements is essential in obtaining real savings. A recurrent theme throughout the various surveys and studies is the need to keep positions vacated for an extended period of time (at least three to five years). Too much emphasis on short-term savings often leads to the eventual refilling of positions, which results in long-term retirement expenditures and only short-term salary reduction. As a rule of thumb, ERI plans generally have not resulted in net cost savings when more than SO% of the vacated positions are filled.

As mentioned above, the type of incentives offered under an ERI plan can heavily influence the participation rate. For example, if a younger population is targeted, benefits may need to be more attractive to bridge the gap before Social Security benefits commence. Therefore, incentives need to be designed to generate the desired number of retirements in order for the state to achieve its goals. At the same time, careful consideration must be given to provide incentives that are not too generous or give away benefits to those participants who would be likely to retire anyway.

Another key consideration is the window period. A longer window period has the effect of subsidizing retirements that would occur regardless of the incentive plan; however, the window period should provide employees adequate time to make an informed decision to avoid any potential violation of the Age Discrimination in Employment Act which prohibits involuntary retirement of older workers through the use of ERI plans.

Of similar concern is the issue of reopening the window. Offering repeated windows may impair the effectiveness of the incentive program by making the window, in effect, a permanent benefit improvement, thereby increasing retirement costs as a result of providing subsidized early retirements. It may also encourage employees who might normally retire to postpone doing so until the next incentive program is offered. To the extent this occurs, the number of retirees accumulate and when an incentive program is offered, all leave the employer collectively, causing a major loss of experienced personnel all at once. Therefore, if the objective of the incentive program is to maximize savings, consideration should be given to limit the offering to no more than once every five-to-seven years.

Specific State Studies of ERI Plans - Once established, few states monitor their ERI plans to see if they really work. The general lack of record-keeping and analysis regarding costs and/or savings of such plans is a major concern which states have just recently begun to address through improved accountability procedures.

Presented below are those states which have provided studies of their ERI plans and a brief summary thereof. Copies of such studies are available upon request.

• *New York* - In 1983 New York offered an ERI plan which was primarily intended to reduce pay-roll cost by downsizing the state's work force through attrition. Where services were considered essential, it was assumed that long-term employees would be replaced with new employees who would be hired at lower salaries, thereby reducing payroll costs.

The ERI plan provided that, with few exceptions, individuals in paid state service on January 31, 1983 could retire between March 1, 1983 and May 31, 1983 and receive an additional three years of retirement credit if they were otherwise eligible to retire. During the three-month window period, 8,060 of 26,566 eligible state employees actually retired (30%). The average cost of the additional retirement benefit was $13,335 per member. The total cost to the State of New York was $145 million (including interest), amortized over a five year period. The first payment by the state in the amount of $29.5 million was made in June 1984. A subsequent study revealed that nearly half those who chose to retire under the incentive program stated that they would have retired anyway.

The ERI plan was premised on the condition that if the state maintained the discipline of the work force reduction program over the five year period during which the cost of the incentive program was being amortized, the savings in terms of reduced payroll costs would exceed the expenses of the additional retirement benefit. On the other hand, if the jobs which were vacated during 1953 were refilled during the five year amortization period, there would be a net cost to the state.

Fiscal discipline was not maintained by the state. When the state adopted its retirement program in the spring of 1983, there were approximately 219,000 employees on the state payroll. Three months later the incentive plan and ordinary attrition had reduced the work force to approximately 211,000, which indicated a substantial savings in payroll costs. One year later the work force had risen to 215,000 and continued to grow. As a result, what was supposed to be a net savings of $50 million ended up costing $5O million instead.

A study of the 1983 ERI plan concluded: "While some savings may be realized because new employees are usually hired at a lower rare and generate lower retirement costs, these savings, by themselves, are not sufficient to guarantee a net savings. Real savings will result only if positions left vacant by retirement remain vacant." The study recommended that strict adherence to a permanent work force reduction schedule be required by employers that offer ERI plans to their employees. The study also made the observation that it is very difficult to predict how employees will react to an incentive program. As an example, it pointed out that the State Division of the Budget originally estimated that 3,4OO state employee would retire under the program and the retirement system's estimate was 5,000. Both were significantly under the 8,060 actual retirements.

The study reached the following conclusions with respect to the age, service, salary and other demographics of the individuals electing to participate in the ERI plan:

- The proportion of employees who elected to retire under the ERI plan increased sharply with age. Relatively few employees under age 60 chose to retire while a relatively high proportion of those over age 60 (particularly age 65) chose to retire;

- The proportion of employees who elected to retire under the ERI plan increased steadily with service. Relatively few short-service employees retired under the program, while relatively more long-service employees retired under the program;

- The proportion of employees who took advantage of the program decreased with salary. Relatively more low-paid than high-paid employees elected to retire under the program;

- Once eligibility for Social Security benefits was attained (age 62), the proportion of those electing the program increased dramatically.

As part of the efforts to balance the 1990-91 state budget, New York adopted another ERI program in 1990 which was primarily intended to achieve significant cost savings through permanent reductions in the state work force, while minimizing employee layoffs. The features of this program differed significantly from those that were offered to state employees in 1983, largely due to the bitter experience with the 1983 program.

Under the 1990 program, three distinct ERI plans were offered to certain employees working in the three branches of state government: a targeted incentive plan; a phased retirement plan; and a non-targeted plan. For employees of the executive branch there were two plans made available: the targeted incentive plan and the phased retirement plan.

Under the targeted incentive plan, employees already eligible to retire with at least ten year of service and in a targeted position could receive one month's additional service credit for each year of service, up to a maximum of three years. Agency heads, with the approval of the Governor's Budget Director, determined which positions within the agency would be targeted for participation in the plan. Employees serving in these targeted positions in a large agency who applied for retirement between June 15, 1990 and August 31, 1990 with an effective date of retirement prior to September 30, 1990 received the additional credit. Employees serving in a targeted position in other than a large agency were required to apply for retirement between June 15, 1990 and July 31, 1990 and retire before August 31, 1990. Where the number of applicants exceeded the number of targeted positions, participation in the plan was based on seniority. The legislation also required the abolition of all targeted positions when they were vacated upon the member's retirement. In determining which positions would be targeted, consideration was given to whether elimination of such positions would reduce the level of services required or mandated to protect and care for clients of the state or to assure public health and safety; endanger the health and safety of state employees; result in substantially increased overtime or contractual service costs; or significantly impair the operation of the agency or a program within the agency. Accordingly, the targeted nature of this incentive was designed to provide for a permanent cost saving reduction in the state work force without a disruption in the delivery of fundamental or essential services to the public and to avoid the fiscal and programmatic costs of the 1983 ERI program.

For the phased retirement plan, employees of the executive branch who were at least age 55, eligible for retirement and in the active service on June 4 could apply for service retirement between June 15, 1990 and August 31, 1990 with an effective date before September 30, 1990. As a precondition for this plan the employee agreed in writing to continue employment full-time in the position from which the employee had retired for at least six months but not longer than two years. Employees who retired under this incentive plan were entitled to collect their full retirement benefits during their full-time employment while receiving 60% of the salary they were earning at the time of retirement (adjusted upward by the same pro rate share of any general salary increases). Following the conclusion of participation in the phased retirement plan, the employee's retirement benefit was recalculated to credit any additional post-retirement service rendered under this plan.

The non-targeted plan provided legislative and judicial employees a retirement incentive benefit virtually identical to that offered employees of the executive branch under the targeted plan. This plan, however, differed in that eligibility for the benefit was not targeted to specific positions and positions vacated by retirement were not automatically abolished.

A total of 2,405 state employees retired under the three ERI plans, with 1,639 retiring under the targeted incentive plan, 572 under the non-targeted plan, and 194 under the phased retirement plan. This total is less than one-third of the number who retired under the 1983 program.

The average incentive service award was approximately 2.13 years of service for the 2,211 participants who retired under the 1990 targeted and non-targeted plans. This is in contrast to the three full years of incentive credit that was awarded under the 1983 program.

The total cost of the 1990 program was estimated to be $46.1 million. Of this amount, approximately $29.2 million represented the cost of providing benefits to members who retired under the targeted plan, full payment for which was due prior to March 31, 1992. The cost of the non-targeted plan was approximately $13.5 million, of which $0.4 million relates to legislative employees and the remaining $13.1 million relates to judicial employees. The legislative portion was due prior to March 31,1992 and the judicial portion is payable in annual installments over a period of five years. The first judicial installment in an amount of approximately $3.1 million was due prior to March 31, 1992. The cost of the phased retirement plan was approximately $3.3 million payable prior to March 31, 1992.

The targeted incentive plan was estimated to produce a net savings of at least $35 million in the twelve months following the window closing due to the abolition of the targeted positions. Assuming these positions were not re-established and filled, it would also result in a permanent reduction in the state work force of 1,639 positions and an annual savings of $64 million in salary costs.

Because the non-targeted incentive plan did not require an abolition of the positions vacated by retirement, the amount of the cost versus savings could not be readily discerned.

The phased retirement plan was estimated to produce a net savings of approximately $400,000 due to the payroll savings achieved by paying retirees only 60% of their previous salaries.

• *Colorado* - In 1987 Colorado adopted an ERI plan to "reduce expenditures for personnel employed by the state and its political subdivisions." The legislation instructed employers to replace retirees "with employees at such classes and pay grades as is determined to maximize the reduction of expenditures for personnel."

The ERI plan, known as the Modified Rule of 75, permitted employees who were at least age 55 to retire with no reduction in benefits if their age and years of service totaled 75. Eligible employees were required to retire between July 1, 1987 and August 31, 1987.

The legislation also required deferral of the payment of accumulated sick leave. Normally, retirees receive payment of one-fourth of their accumulated sick leave upon retirement. Under the ERI plan, half the payment was deferred until one year after retirement; the other half was deferred for two years.

During the two-month window 1,327 of 3,940 eligible employees retired (34%). According to the study, the ERI plan generated 770 new retirements which would not have occurred otherwise.

The incentive plan achieved its statutory purpose of reducing personnel expenditures though at some cost to the retirement system. The study indicated that the state and political subdivisions saved about 9.5 million in personnel costs over five years.

However, the retirement system absorbed $59.3 million in increased pension costs over the lifetime of the retirees as a result of the incentive program. This represented about 0.1% of payroll. To pay for these costs, the amortization period was increased by two years rather than increasing the employer contribution by 0.1%. The amortization period prior to the incentive plan was 16 years for the state division, 10 years for the school division and 5 years for the municipal and judicial divisions, all of which were well below the pension industry guideline of 40 years and the statutory guideline of no more than 60 years.

In addition, the retirement system absorbed over $3 million in additional health care costs for those persons retiring under the incentive program. The study indicated that the ERI program may have had the greatest relative impact upon the system's health care fund as retired persons under age 65 cost four times as much as those over age 65. Concerned about the impact of early retirement programs on the long-term costs of pension funds, the study recommended that the retirement system provide an estimated dollar cost to the legislature to assist in decision-making should additional early retirement programs be proposed.

The study also cited short notice between the passage of the legislation and the effective date of the program as a problem for employers, eligible employees and the retirement system. Employers and the retirement system had only two weeks to set up the program and prepare for the retirements. Eligible employees had only two months to obtain information and make a decision regarding retirement Court cases have used "insufficient time" to test whether the retirements under an incentive program were voluntary. Accordingly, the study recommended that, in any future early retirement programs, the legislature should allow enough notice between passage of the bill and the effective date of the program so all affected parties may prepare for implementation.

• *Alaska* - In 1989 Alaska reestablished an earlier ERI plan for employees covered by either the Public Employees Retirement System (PERS) or the Teachers' Retirement System (TRS) to reduce personnel service costs through voluntary retirement rather than through layoffs.

Under the incentive plan, employees had to meet both the basic criteria established in the enabling statute in addition to any special criteria established by their employer in order to receive an additional three years of service credit. The basic criteria required that the employee be eligible for normal retirement or early retirement after the inclusion of the incentive credit. Individuals covered by PERS must be at least age 55 with five years of service for normal retirement or age SO with five years of service for early retirement. Individuals covered by TRS must be at least age 55 with eight years of service for normal retirement or age 50 with eight years of service for early retirement.

Additional eligibility criteria were established by the Office of Management and Budget (OMB) for state employees: no state employee was eligible for the incentive program unless his or her employer could demonstrate that the savings in salary and benefits projected over three years between such employee and his or her replacement would exceed the employer's cost of providing the incentive, including an administrative fee of $140 for processing the claim. OMB required that savings be demonstrated for each individual in order to maximize cost savings. It felt that netting the savings generated by one employee's participation against the cost of another who did not generate a savings did not fully meet the legislative intent regarding the reduction of personnel service costs. OMB also required that the only types of savings that could be considered would be the difference in salary and benefits of the outgoing retiree and their replacement or the elimination of the position altogether. Savings from vacancies, differences in leave accrual rates and "domino-effect" savings realized through the replacement of a lower-paid employee down the chain of the organization could not be considered.

In many cases, a long-term employee working in a position that was going to continue after his or her retirement could not generate enough projected savings over a three-year period to cover the employer's costs under the incentive program. In 1990 legislation amended the incentive program to allow the employer to calculate projected savings over a five-year period rather than a three-year period and to allow the employee to pay part of the employer's cost in order to provide for more participation.

At least one local government employer required the employee to pay the full costs involved in providing the retirement incentive credit in order to be eligible to participate in the ERI plan.

Largely as a result of this requirement only one individual elected to participate in the incentive program.

The study indicated that almost 1800 employees participated in the 1989 incentive program. It concluded that the program paid for itself and saved participating employers an estimated $22.9 million over three years. The savings were generated mostly by the incremental difference in the salary and benefit costs between the typically higher-paid ERI participant and their lower-paid replacement rather than realized from any extensive elimination of positions.

It further concluded that the program generated a net reduction in personnel service costs, though the budget impact was uncertain. Identifying savings for legislative consideration is often difficult. Such savings often get lost in a variety of budgetary incremental adjustments such as those generated by new union contracts, new positions for new programs, new positions for old programs, adjustments for vacancy and turnover, etc. It noted that often times employers take advantage of the flexibility afforded from the reduction of personnel service costs to reallocate and use the savings without legislative budgetary oversight The lack of a budget control process limits the legislature in performing its oversight function. Decision-making is transferred to agency administrators who decide how to reallocate or use savings, with no specific legislative inquiry or direction. Accordingly, the study recommended that an ongoing monitoring and control procedure be established which would provide greater assurance that ERI-generated savings are being used to reduce personnel service costs, identify more clearly the amount and impact of program savings, and provide the legislature a decision-making role in how savings are to be reallocated.

• *Kentucky* - In 1988 Kentucky offered state workers an ERI plan. The purpose of the incentive plan was "to bring expenditures in line with general fund revenues."

The ERI plan provided for an additional 10% service credit. Employees covered by the Kentucky Employees Retirement System (KERS) and the State Police Retirement System (SPRS) who were hired on or before January 1, 1988 were eligible to participate in the plan. In addition, former employees who were hired on or before January 1, 1988 and who met the service requirements were also eligible for the 10% additional credit. The plan required eligible employees to retire during a three-month window period between August 1, 1988 and November 1, 1988.

The total number of employees who elected to participate in the ERI plan was 1,876, or 15% more than the projected number of 1,610. Of these retirees, one-third originally had planned to retire anyway, leaving two-thirds electing to retire earlier than they normally would have. The average early retiree would have continued to draw a salary for another 22 months had the ERI plan not been offered. Just over 100 retirees had been retained by their former employer for some period after retirement as part-time, on-call, or contract employees. Fifty percent of the vacated positions had been refilled, and 40% of the positions were eliminated. On average the salary of a new hire was about 25% less than the retiree's former salary.

The cost of the ERI plan was borne by the agency whose employees elected to participate. Two major costs were assumed by the agencies at the time of retirement. First, agencies were responsible for paying the accumulated leave and compensatory time of their retirees which amounted to approximately $9.5 million. Second, agencies were required to pay the cost of the additional service credit offered to former employees which amounted to $20.5 million. The cost of such service was payable upon the last day of the month in which the employee terminated or in two equal installments. If the agency chose to bear the cost in two installments, the first installment equaled 50.481% of the total cost and was due on the employee's termination date, with the second installment payable within 90 days thereafter.

The study found that the net cost of the ERI plan to Kentucky state government was $6.8 million in fiscal year 1989 because each state was obligated to pay the service credit costs and accumulated leave and compensatory time for employees who retired early. On the other hand, the state saved $3.7 million in fiscal year 1989 due to the Governor's hiring freeze. Together, the state incurred net costs of $3.1 million in fiscal year 1989.

By the end of fiscal year 1990, however, the ERI plan was estimated to generate $22 million in net savings. The hiring freeze was estimated to save an additional $9.2 million. Thus, the combined net savings of the ERI plan and the hiring freeze would be $31.2 million by the end of the 1990 fiscal year. It should be noted that unlike the Colorado ERI plan, the Kentucky ERI plan did not shift any costs from the current operating budget to the state retirement systems. Such costs were paid in full at the time of retirement by the individual agencies whose employees retired under the incentive plan.

The study indicated that loss of essential skills and program knowledge were seen as the biggest immediate problems resulting from the ERI plan. On the other hand, greater staffing flexibility, program savings and elimination of non-productive personnel were seen as the most immediate benefits of the incentive plan.

The study further indicated that while the ERI plan was successful in encouraging relatively large numbers of employees to retiree, the size of the state workforce has actually increased in every branch of state governments since the plan was implemented.

• *South Carolina* - In 1991, the South Carolina Legislative Audit Council conducted a study on various retirement incentives. Based on that study, it found that the state could achieve cost savings by implementing a carefully planned and managed retirement incentive program for state employees, and suggested that such program should be accompanied by a controlled downsizing to realize savings.

The study assumed that no more than 50% of the vacated positions would be filled at a 75% salary level, and suggested that a legislatively mandated replacement policy be adopted to ensure that the retirement incentive resulted in cost savings for the state. If agencies lost the positions of employees who retired under the incentive program and the funding associated with those positions, they could request the reinstatement of critical positions through the Budget and Control Board, which would be responsible for ensuring that the legislative mandates were met.

The study examined three different types of retirement incentives: an additional five-year service credit; a $7500 cash bonus; and no penalty for early retirement. The study based its cost/savings analyses on two different funding methods: funding the costs of the incentives over the state retirement system's 27-year amortization period and funding the costs over a 5-year period.

Adding five-years of service credit to those eligible to retie was estimated to be the most costly of the three incentives and the most attractive to employees. The study estimated that 50% of eligible employees would retire under this incentive, compared to an estimated 30% under the other two incentives. It further estimated that the state could realize first-year savings of $26.7 million and as much as $39 million in subsequent years if the costs were amortized over 27 years. However, if the costs were paid over 5 years, the state could suffer a $11.7 million first-year loss, with no significant savings realized during the remainder of the 5-year period.

An appendix to the study does note that estimates of savings become less valid the further they are projected in the future, and are probably of little validity after the first few years. This is because employees who retire as a result of the incentive probably would retire anyway within a few years and, with the passage of time, it becomes increasingly difficult to pinpoint specific positions saved or filled as agencies change their functions and organization. It goes on to state: "It is probable that with the 27-year method of paying for the benefits, the costs would continue longer than any savings as a result of the incentive."

The $7500 cash bonus is the least costly of the three incentives and probably the least attractive to employees. If the costs were paid over five years, the study estimated that the state could realize first-year savings of $19 million, with annual savings of $26.5 million for years two through five. There are no actuarial retirement costs associated with this type of incentive. As such, costs can be more accurately estimated and can be. tailored to correspond to expected short-term savings from such incentive. Also, any expenses incurred can be considered within the normal budgetary process.

Eliminating the penalty for early retirement is not an incentive for those employees who are already eligible for normal retirement, and is generally offered in conjunction with other incentives such as the granting of additional service credit. However, for purposes of this study, the cost/savings analysis was based on the mere elimination of the early retirement penalty. If the costs were paid over five years, the study estimated that the state could realize first-year savings of $5.2 million, with annual savings of $9.7 million during the second through fifth years. These lower savings result from a smaller pool of eligible employees.

The study recommended to the state legislature that a retirement incentive plan should be authorized for state employees, and that the plan should include:

- Eligibility criteria for participation;
- Provision for funding the cost of the increased benefits;
- Controls over filling positions vacated by retirees;
- Provision for monitoring and reporting the results of the incentive.

In 1993, the South Carolina state legislature enacted a retirement incentive plan. Under the terms of the plan, employees electing to retire no later than July 1, 1994 were eligible to receive a special payment of $7500 or 25% of salary, whichever is greater. The retirement eligibility requirements remained unchanged. Final results are expected in October.

• *Maine* - In 1991, the Maine state legislature enacted a rather unique retirement incentive program to reduce personnel costs. Unlike most other incentive programs with like aims, Maine's program was not predicated on abolishing positions or keeping positions vacated over a period of time. Instead, under this program, eligible employees could request the approval of their employer to retie and continue to work in their position at a reduced salary.

More specifically, employees who were eligible for normal retirement prior to July 1, 1992 could request to retire from their position and return to work in the same position at 80% of their former salary for up to three years. Because of operational concerns and cost factors, employees were required to obtain the approval of their employers in order to participate in the incentive program. The employer could deny participation for any of the following reasons: the employee's participation would have an adverse impact on operational goals and objectives of the department; the costs to be incurred by the employee's participation would exceed the savings to be realized; or the employee's participation would adversely affect the work plans developed by the department to stay within its authorized budget. Participation in the program was conditioned upon the employee remaining in the position held at the time of retirement; any transfer or promotion to another position would subject the employee's retirement benefits to the state retirement system's earnings limitation. Employees who participated in the incentive program did not accrue any additional retirement credit for the period of re-employment, and were not entitled to any other benefits that accrue to active members of the retirement system However, employees were eligible to defer income on a voluntary basis under various deferred compensation plans offered by the state.

In 1993, the Maine state legislature offered the same incentive program for state employees who were eligible for normal retirement prior to July 1, 1994, with the following two exceptions:

- Employees electing to participate in the program were paid 70% of their former salary;

- Employers were required to contribute on the participant's full salary at the time of retirement that portion of the employer contribution rate that went toward the unfunded liability, retiree health care and administrative costs for the entire period of reemployment.

According to the director of the state retirement system, the two incentive programs have resulted in net savings to the state with no adverse fiscal impact upon the retirement system.

Ohio's Experience with ERI Plans - In 1983, the Ohio General Assembly enacted H.B. 410 which authorized employers to establish ERI plans for members of the State Teachers Retirement System (STRS) and the School Employees Retirement System (SERS). In 1986, H.B. 706 granted employers similar authority to offer such plans to members of the Public Employees Retirement System (PERS), with few exceptions. These incentive plans are not provided under the Police and Firemen's Disability and Pension Fund (PFDPF) or the Highway Patrol Retirement System (HPRS), largely due to the normal retirement provisions of these systems which allow members to retire as early as age 48 with 25 years of service.

Generally, the laws of PERS, STRS and SERS grant employers broad discretionary authority to adopt ERI plans for the purchase of additional service credit. Once established, these plans must remain in effect for at least one year. The employer must pay the full amount specified by the retirement system equal to the additional actuarial liability resulting from the purchase, as determined by the system's actuary. Employees who qualify or will qualify for service retirement with the incentive credit and who agree to retie within 90 days after receiving notice that the service credit has been purchased are eligible to participate in the plan. The amount of service purchased by the employer must be uniformly determined, but must not exceed the lesser of five years or 20% of the employee's total service credit. The employer may limit participation in the plan, provided such plan is offered to at least 5% of the employees. If participation is limited, employees with greater service have priority over employees with lesser service.

The statutory authority under the three retirement systems is essentially the same, though there are certain differences. First, STRS and SERS members must be at least age 50 to be eligible to participate in an ERI plan. No minimum age requirement is provided under PERS law. Second, PERS law specifically excludes certain members from participating in an ERI plan, such as elected officials, members of boards or commissions, and law enforcement officers. No specific employee groups are excluded under STRS and SERS. And finally, PERS law provides for mandatory adoption of ERI plans in the case of certain closings of and mass layoffs at state institutions. There are no employer mandates under STRS and SERS.

Ohio's statutory authority relative to the establishment and use of ERI plans incorporates the following key features. First, it is made a permanent part of the state retirement systems' laws, unlike many other states where such legislative authority is granted on an ad hoc basis. As a corollary, Ohio's public employers may adopt ERI plans on an ongoing basis, whereas other states often authorize the use of such plans for specified time periods only. Second, the decision whether to offer an ERI plan is largely left to the discretion of individual employers, who may also decide within certain parameters the number of eligible participants as well as the number of years to be purchased. This broad discretion maximizes "local control," allowing individual employers to offer such plans for a variety of reasons and providing employers some flexibility in the design of such plans to achieve their goals. Other states often place various restrictions on employers, thereby maintaining greater legislative control over their early retirement programs. Third, unlike other states where ERI plans often have the effect of simply shifting costs from the employer to the state pension funds, ERI plans offered in Ohio have no adverse fiscal impact on the state pension funds because the law requires the individual employer to pay the additional liability resulting from the incentive program as certified by the system's actuary. Fourth, ERI credit cannot be used to qualify members for health care coverage after retirement (effective September 1, 1996 in STRS). The continuation of health care coverage for early retirees and their dependents has become one of the most expensive enhancements in other states' ERI plans. Lastly, it is important to note that the Ohio General Assembly has mandated the use of ERI plans in the case of certain state institutional closings and mass layoffs, irrespective of the costs involved. This legislative mandate recognizes the use of ERI plans for purposes other than strictly cost savings.

The three tables appearing at the end of this report summarize information made available by PERS, STRS and SERS relative to ERI plans adopted by public employers. These tables indicate a widespread use of such plans among various public employers, particularly public educational employers.

In 1987 STRS conducted a survey of those employers and employees who participated in an ERI plan between August 7, 1983 (the effective date of STRS' enabling legislation) and June 30, 1986. That survey indicated that ERI plans were most popular among universities, followed by city school districts and community colleges, and least popular among technical colleges and joint vocational schools. Employers cited "cutting expenses" and "replacing staff' as their top two objectives in implementing ERI plans, followed by "rewarding staff' and "reducing staff." A majority of employers met their objectives. Cutting expenses, the most popular objective, was also the one most often not met by employers. The highest percentage of employers offered to buy three years of credit. The vast majority of ERI plans were in effect for one year, though a few employers offered such plans on a seemingly permanent basis. Half of the employers limited employee participation to the minimum 5% required under the law, though a substantial number set no maximum at all. Slightly less than a quarter of the employers indicated an intent to re-adopt an ERI plan within five years, while an additional 20% stated that they would offer a plan "as needed." Over half of the employers adopted an ERI plan as a result of an agreement with an employee organization.

The survey indicated that over two-thirds of the participating employees were elementary and secondary school teachers; another 14% were in higher education; and 18% were administrators. Nearly two-thirds of the employees were age 55 to 64. The vast majority of them (82%) had at least 25 years of service prior to the incentive credit, with over half having more than 30 years. Slightly more than one-third received three years of credit, while slightly less than one-third received the maximum five years allowed under the law. Without an ERI plan, approximately three-quarters of the employees indicated that they would not have retired; nearly two-thirds of the employees said that they would *not* have retired if the employer had purchased fewer years, though roughly one-third would have retired anyway. Nearly one-half of those retiring under an ERI plan had no plans to seek employment- Only 10% had secured or planned to secure full-time employment, while slightly over one-third had obtained or planned to obtain part-time employment.

Other Issues For Further Study - Beyond the "mechanics" of offering an ERI plan, there are several public policy and legal issues which warrant consideration.

• *Changes in Federal Policy* - Federal legislation has been enacted to encourage greater participation of older persons in the labor force.

The 1983 amendments to the Social Security Act are a case in point. These amendments will gradually increase the normal retirement age from 65 to 67. Workers retiring at age 62 will have a 30% reduction in benefits compared to the current 20% reduction. Individuals retiring at age 65 will have a 13% reduction compared to no reduction today. These amendments were made to increase labor force participation of older workers, reduce Social Security costs, and increase contributions to the Social Security trust funds.

Also, the 1978 amendments to the Age Discrimination in Employment Act (ADEA) eliminate mandatory retirement for nearly all employees in both the private and public sectors. These amendments were enacted to promote the employment of older persons based on ability rather than age as well as to prohibit arbitrary age discrimination in employment

These federal policies indicate a congressional intent to keep older employees in the workforce for longer periods of time. ERI plans operate to do just the opposite.

• *ADEA Constraints* - The ADEA prohibits age discrimination in employment as well as employee benefits for persons over age 40. It allows for ERI plans as long as they are "consistent with the relevant purposes of ADEA." Under no circumstances may an employer require the involuntary retirement of an older worker through an ERI plan. Plans which do not provide the member sufficient time or accurate information to make an informed decision whether or not to retire may be considered involuntary under the ADEA. Also, plans which provide an upper age limit on employee participation or which provide different benefits or apply offsets to certain classes of employees may give rise to an ADEA claim.

• *Section 415 Limits* - Section 415 of the Internal Revenue Code generally prohibits a qualified pension plan from paying an annual pension which exceeds the lesser of a specified dollar amount or 100% of the employee's average three-year compensation. For governmental plans, the federal dollar limit is actuarially reduced for each year prior to age 62. The compensation limit is reduced by any tax-deferred amounts, including picked-up employee contributions and amounts paid into the Ohio Public Employees Deferred Compensation Program, a Tax-Sheltered Annuity Plan or a Cafeteria Plan. Qualified plans may not pay benefits which exceed these lower limits for early retirees in order to maintain their favorable tax status.

• *Section 401(a)(4) Non-Discrimination Requirements* - Section 401(a)(4) of the Internal Revenue Code generally prohibits qualified pension plans from discriminating in favor of highly-compensated employees relative to employee benefits. This section applies to any subsidized or optional benefits such as those offered under an ERI plan. These federal non-discrimination requirements must be considered in cases where the ERI plan targets a select group of employees.

Conclusion - ERI plans vary from state to state. The law authorizing ERI plans in Ohio is a permanent part of the retirement statutes of PERS, STRS and SERS. The law maximizes "local control," allowing individual employers to offer such plans at their discretion and providing them some flexibility in the design of such plans to achieve their objectives. Most importantly from the perspective of this Commission, the law protects the actuarial soundness of the state retirement systems by requiring the individual employer to pay the additional liability resulting from the incentive plan as determined by each system's actuary. In other words, the law precludes employers from shifting costs to the retirement systems.

State Teachers Retirement System

Summary of ERI Plans: 1984-1994

Plan Year	Voluntary Plans[1]	Participants	Total Years Purchased	Average Years Purchased	Total Employer Cost	Average Cost Per Year	Average Cost Per Retiree
1984	31	144	522	3.63	$4,111,311	$7,876	$28,551
1985	245	1,438	5,051	3.51	$45,551,687	$9,018	$31,677
1986	301	1,683	5,712	3.39	$54,208,754	$9,490	$32,210
1987	319	1,013	3,515	3.47	$37,179,826	$10,577	$36,703
1988	352	1,337	4,180	3.13	$52,047,717	$12,452	$38,929
1989	369	898	3,151	3.51	$46,509,454	$14,760	$51,792
1990	386	1,049	3,212	3.06	$44,924,466	$13,986	$42,826
1991	405	811	2,317	2.86	$35,447,694	$15,299	$43,709
1992	414	860	3,123	3.63	$55,489,708	$17,768	$64,523
1993	424	806	2,652	3.29	$45,466,061	$17,144	$56,410
1994	432	952	2,727	2.86	$47,046,623	$17,252	$49,419
Total[2]	432	10,991	36,162	3.29	$467,983,301	$12,941	$42,579

[1] This column shows the cumulative number of employers adopting ERI plans.
[2] Since the enactment of STRS' enabling legislation in 1983, one-half of STRS' employers adopted ERI plans. Of these employers, about one-half had adopt[illegible] two [illegible]ore plans. Over 800 plans have been initiated in total.

School Employees Retirement System

Summary of ERI Plans: 1987-1993

Plan Year	Voluntary Plan	Participants	Total Years Purchased	Average Years Purchased	Total Employer Cost	Average Cost Per Year	Average Cost Per Retiree
1987	72	332	880	2.65	$3,811,441	$4,331	$11,480
1988	72	226	617	2.73	$3,468,964	$5,622	$13,041
1989	46	374	1,088	2.91	$6,673,388	$6,134	$17,843
1990	31	258	764	2.96	$5,128,652	$6,713	$19,878
1991	36	283	849	3.00	$4,117,721	$4,850	$14,550
1992	30	228	547	2.40	$3,862,261	$7,061	$16,940
1993	32	141	367	2.60	$2,167,469	$5,906	$15,372
Total[1]	319	1,842	5,112	2.78	$29,229,896	$5,718	$15,869

[1]Since the enactment of SERS' enabling legislation in 1983, nearly 2,800 school employees have retired under ERI plans. Employers have purchased approximately 7,500 years of service at a total cost of just under $39 million. The average cost per retiree is just over $14,000 with an average purchase of 2.7 years.

Public Employees Retirement System

Summary of ERI Plans: 1987-1993

Year	Voluntary Plan	Mandatory Plan	Participants	Total Years Purchased	Average Years Purchased	Total Employer Cost	Average Cost Per Year	Average Cost Per Retiree
1987	42	1	1,798	6,987	3.89	$58,800,659	$8,416	$32,703
1988	32	2	1,615	5,935	3.68	$55,245,629	$9,308	$34,208
1989	28	3	980	3,965	4.05	$36,194,820	$9,128	$36,933
1990	17	0	705	2,148	3.05	$20,093,099	$9,354	$28,501
1991	34	11	837	2,616	3.13	$29,188,123	$11,156	$34,872
1992	32	11	1,568	5,382	3.43	$65,669,974	$12,201	$41,881
1993	26	6	781	1,799	2.30	$18,588,480	$10,333	$23,801
Total	211	34	8,284	28,832	3.48	$283,780,784	$9,843	$34,256