South Dakota Legislative Research Council

Issue Memorandum 97-12

Public Employee Retirement Issues

(Revised, December 1998)[1]

Invariably, legislation comes before both houses concerning the South Dakota Retirement System (SDRS), a facet of state government which affects nearly 55,000 South Dakotans and their families, from all areas of the state and from all walks of life. However, public employee retirement fund organizations, and the legislation surrounding them, can be dense clouds of specialized terminology and actuarial data, shrouding the very real effects that retirement systems can have on real people.

This issue memorandum will attempt to accomplish three goals. First, to provide a reference for the most basic terms and concepts utilized in retirement legislation and in retirement system reports and literature. Second, to concisely explore the methods, structure, and statistics of the South Dakota Retirement System. And third, to compare SDRS to other public retirement systems nationwide, pointing out the broad range of methods used in the United States in supplying public employees with pension funds.

MAJOR CONCEPTS

Defined Contribution versus Defined Benefit

The two terms, defined contribution and defined benefit, essentially name the two simplest ways of organizing a retirement fund. Under a defined contribution plan, the employee is given an "account," into which he deposits as much or as little of his income as he would like. The employee usually also has a choice of investments for his account, ranging from low-risk to high-risk. The employer may also match the employee's deposits. The money is invested for the employee by a third party, and the employee's future retirement income depends upon two major factors: how much he contributed and how well his investments did. Since his retirement depends so heavily on how much he contributed, the plan is known as a defined contribution plan--the contribution is the defining factor.

Defined contribution plans are widespread throughout *private* employers (an example is a 401(k) plan). However, the vast majority of *public* retirement plans (like SDRS) are defined benefit plans. Under such a plan, the employee and/or the employer pay a set amount of one's salary into a wide-ranging plan (not merely into individual accounts). The plan's administration invests the total funds using a diversified investment approach, allotting pension benefits to current retirees and also building up a fund for future retirees. When an employee retires, his pension is calculated using a benefit formula, which normally has three basic components: the average final salary of the employee, multiplied by the length of service, multiplied by a benefit multiplier fixed by a legislative body. Therefore, an employee is able to figure the amount of his future benefit before he even retires, and guesswork is far more limited. Therefore, this type of plan is known as defined benefit.

Benefit Formula

A public employee retirement system's benefit formula can be one of the most mind-numbing aspects of the plan. In some states, legislation has changed the formula, and more importantly the underlying plan behind the formula, so many times that dozens of permutations could result. In Oklahoma, for instance, all service before 1994 is used with one multiplier, whereas all service after 1994 is used with another. Unused sick leave and military service are then figured into the post-1994 amount, and a salary cap for pensions has also been recently removed. In South Dakota, the benefit formula is normally a far easier formula to understand, however. Nationwide, benefit formulae normally follow a basic pattern: credited service x final average salary x benefit multiplier = annual retirement benefit. Credited service is normally straightforward, but can include prior public service under a different employer purchased by the employee, or in some states military service as well. Final average salary is normally defined by the mean of the last three years' salaries earned by the participant, though there are variations on this norm. The benefit multiplier is a figure which the legislature is able to control, and thus may change as the financial health of the plan changes. The multiplier is usually different for different plans or types of employees. For example, teachers have different multipliers than judges. A higher multiplier can offset the effects of a shorter career (e.g., judges or police officers) if that is the legislature's intent.

What is important to understand is that benefit formulae are not set in stone. South Dakota's benefit multiplier has been changed by the legislature seven times over the last two decades. Also, for retirees, cost of living increases (COLAs) normally exist to help pension payments keep pace with inflation. South Dakota's COLA, or improvement factor, is currently 3.1% annually.

Vesting Period

Obviously, not all individuals who start out as public employees will stay in that career. Many inevitably move on to the private sector. What happens to their contributions in a defined benefit plan? The answer differs from state to state, but in almost all cases, the deciding factor is how long the employee has participated in the system. After a certain number of years decided by statute, normally from five to ten, the participant becomes "vested" in the plan, which means that he can leave his funds within the plan and draw a partial retirement benefit upon reaching retirement age. In South Dakota an employee is vested after three years of service.

If a participant leaves public employment before being vested, two choices are normally available. Either the employee can withdraw the funds he has contributed to the plan (here "withdraw" includes the right to roll those funds into another plan or another investment option, such as an IRA), or the employee may leave the funds within the system for a specified period of time. If the latter choice is taken, the participant can safeguard his retirement future while searching or preparing for another public service position covered under the same plan.

Purchasing Service

If an individual has worked in the public service field in a different state--or for a public service employer not covered under the individual's current retirement plan--most states will allow a public employee to add that time of service to their current service, by "purchasing" it. In other words, the participant may pay all or part of the contributions which he would have made had that prior service been covered under his current plan, and thus add that work time to his length of service under the current employer. To do this, the participant must not be eligible for any kind of retirement benefit based on that prior service.

Though almost all states allow some form of prior service purchasing, the rules of the practice differ greatly from state to state. In some states, such as Arizona, the employee must pay for the entire equivalent of the employee as well as employer contributions for prior service. Some states also allow a participant to purchase military service credit. Some states, such as Oklahoma, will add wartime military service to a participant's length of service without charging a fee.

In South Dakota, an SDRS member may purchase additional prior service at a rate of 75% of the total contribution rate (employee and employer) for each year to be credited. Since the total contribution rate equals 10% of a participant's salary, 7.5% of the participant's annual salary must be contributed for each year of prior service they wish to purchase. Participants may receive service credit for military leave of absence, without employee or employer contributions, so long as they return to their public service job within one year of ending military service.

Supplemental Retirement Options

A number of states, including South Dakota, offer employees an option for supplemental retirement investment. Supplemental retirement plans (or deferred compensation plans, as they are sometimes called) are defined contribution plans which participants may invest in for the sake of greater retirement security. Under such a plan, a participant chooses an account, based on his own risk tolerance (low, medium, or high risk investments), and contributes earnings over and above his defined benefit plan contributions into the account. These funds are invested separately from the funds of the base plan, and upon retirement the participant receives payments from these supplemental investments (contingent upon the success of the investments) in addition to his base pension.

One state, Michigan, has recently made involvement in its supplemental retirement plan mandatory for most participants. This practice is made possible by the fact that Michigan maintains a "non-contributory" defined benefit plan, whereby the employer is the only contributor. This frees up funds for the employee to invest within the defined contribution plan. In South Dakota, as in most states with supplemental retirement plans, however, plan participation is completely voluntary.

Portable Retirement Option

A portable retirement option (PRO) is a retirement choice which is designed to aid those employees who feel they are not likely to retire from (or perhaps even become vested in) their current system. A PRO allows a participant to withdraw a higher percentage of contributions from the system at the time they terminate employment, hopefully with the goal of reinvesting those funds in another retirement or investment plan of some variety.

In South Dakota a portable retirement option was formed in 1995 after years of debate regarding the ability of short-term participants to move more of their retirement funds to new plans upon leaving public employment. In 1998 the portable retirement option was made available to all members through SB 45.

A non-vested member may withdraw both his own contributions into SDRS as well as 75% of his employer's contributions, plus interest, upon terminating employment. Vested members may withdraw 100% of both their own and their employer's contributions upon termination of employment.

HOW SOUTH DAKOTA DOES IT

SDRS History and Organization

The South Dakota Retirement System was formed in 1974, through a statutory consolidation of existing public employee retirement plans within the state. The consolidation was a unique and controversial move by the Legislature at the time, following two years of debate and study. The consolidation legislation appropriated $10.5 million in order to provide an increase to existing retiree benefits and to achieve an 80% funded system. The laws governing the system are found in SDCL 3-12.

SDRS is administered by a Board of Trustees, made up of sixteen voting members and one non-voting member, most of whom are elected by plan participants (representing teachers, retirees, state workers, county workers, etc.). The board selects a full-time administrator to oversee the operations of the system. Since its founding, the administrator for SDRS has been Mr. Al Asher. Both houses of the Legislature maintain a standing Retirement Laws Committee, consisting of five members within each house, and this committee hears all proposed legislation related to the South Dakota Retirement System. SDRS employs 28.2 FTEs, and its offices are located in the Sahr Building, 216 East Capitol, Pierre.

Fiscal Information

SDRS is officially listed under the Department of Labor for budgetary purposes. In reality, however, almost no fiscal or administrative links exist between the two entities. For fiscal year 1999, SDRS was appropriated $2,275,080. SDCL 3-12-61 allows SDRS to utilize up to three percent of annually received contributions towards administrative costs. Since all SDRS operating funds are derived from contributions, appropriations for SDRS always appear as "other funds" in the general bill.

As of SDRS's fiscal year 1997 financial report, the plan held $3,516,630,764 in "net assets held in trust for pension benefits." The Supplemental Retirement Plan maintained $41,580,800 in "net assets available for plan benefits." Most of these funds are handled by the South Dakota Investment Council. Starting in 1997, an annual (as opposed to biennial) actuarial valuation will be made of the system.

Plan Details

As of April 1998 the South Dakota Retirement System consisted of 419 participating units, such as state government, counties, school districts, etc. The plan maintained 54,824 members (33,700 active members, 7,366 inactive members, and 13,758 benefit recipients). There were approximately 3,400 participants in the Supplemental Retirement Plan.

SDRS participation is mandatory for employees of participating units. Two classes of membership exist within the system. Class A membership consists of most public employees and comprises the largest body of participants. Class B, covering individuals who normally have shorter career spans, is divided into two categories: judicial and public safety. All employees and their employers make equal contributions to the system according to the following schedule: Class A members, 5% of compensation; Class B judicial members, 9% of compensation; Class B public safety members, 8% of compensation.

After three years, an employee is vested in the plan, and may leave his contributions under its care in expectation of a future retirement benefit. However, a member terminating public service employment at any point may elect to withdraw the amount of his contributions, with interest, either directly or through a rollover to another retirement plan. A non-vested participant terminating employment may also leave his contributions within the system for up to five years, in anticipation of rejoining the plan again at a later time.

A vested member of SDRS can retire as early as age 55, though 65 is considered the normal retirement age. If an individual wishes to retire between the ages of 55 and 64, the amount of his benefit will depend upon the number of years spent in credited service. SDRS works on a "rule of 85," meaning that an individual over 55 years of age may retire with full benefits if the sum of his age and years of credited service equal at least 85; for instance, a 56 year old with 29 years of service, or a 60 year old with 25 years of service. If an individual under 65 years of age does not meet the rule of 85, that member may still retire, but with a reduced benefit, determined by a scale provided to all members by SDRS.

Once a member has retired, the amount of his annual retirement benefit is determined by a benefit formula: years of credited service x final average salary x the benefit multiplier. Simply stated, the benefit multiplier for Class A members is 1.475%; for Class B judicial members, 3.508%; and for Class B public safety members, 2.175%. As an example, say a Class A member was retiring after 30 years of service, and his final average salary was $30,000. His benefit would be determined by: 30 years x $30,000 x .01475 = $13,275, or $1,106 per month.

Every year, benefit recipients are guaranteed a 3.1% cost-of-living adjustment on their benefits, so the above formula does not become archaic as years go by.

If a member dies while still participating in SDRS, family and spouse benefits are available. If the member leaves behind children under 18, the family receives payments equal to 40% of the member's highest annual salary, plus 10% for each minor child. The member's spouse is also eligible for a benefit once he or she reaches age 65, equal to 50% of the member's projected retirement benefit. Likewise, if a member becomes disabled before age 65, he may apply for a base disability payment equal to 50% of his highest annual salary, with higher benefits available when dependent children exist.

Contacts

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Elmer Brinkman, Watertown, SDRS Board of Trustees, Chair

HOW OTHER STATES DO IT

Variety and Uniformity

Most states have relatively similar public employee retirement plans, which can easily be compared. Such concepts as benefit formulae, vesting periods, and cost of living increases are rather universal among public plans. The vast majority of such plans are defined benefit in nature. Most are governed by a board of trustees, and ultimately overseen by a legislative committee. However, each plan is also unique, and some display radical differences compared to others. The actuarial health and organizational strength of plans can vary greatly, as well as the benefits offered.

Public employee retirement plans in eleven states agreed to share a variety of information for this report, for comparative purposes. These states all have rather well-evolved, and in some cases quite innovative, retirement plans. Comparing the facts and figures behind these plans helps build an understanding of public retirement norms. Exploring the policies of these plans demonstrates the wide range of possibilities within this field. It must be understood throughout, however, that every state is unique, and comparisons in retirement policy can never be seen as completely apples to apples or apples to oranges.

Facts and Figures

In the chart below, the eleven states which submitted information for this study are compared to South Dakota in the following categories: total plan assets, total membership (active, inactive, and retired), the benefit multiplier for the most common worker classification (comparable to a Class A employee), the annual cost-of-living increase, the vesting period, whether or not the plan administers a health insurance policy, whether or not the plan provides a supplemental retirement option, and the plan's assets as a percentage of projected benefit obligations.[2] In some cases, not all information is available.

Twelve-State Comparison of Selected Data

State	**Total Assets**	**Total Members**	**Benefit Multiplier**	**COLA**	**Vesting Period**	**Health Care?**	**SRO?**	**Assets as % of obl.[3]**
Arizona	N/A	250,000	.02	ad hoc	Zero[4]	Yes	No	115%
Arkansas	$2.7 B	57,354	.0165	3%	5 yrs	No	No	102%
California	$108 B	1.06 M	.02	2%	Differs	Yes	Yes	88%
Maine	$2.5 B	89,788	.02	4%	10 yrs	Yes	No	47%
Mass.	N/A	N/A	.025	ad hoc	10 yrs	No	Yes	63%
Michigan	$26.7 B	101,567	.015	3%	10 yrs	No	Yes	82%
New Mexico	$4.8 B	64,076	.02-.03	3%	5 yrs	No	Yes	79%
Oklahoma	$3.16 B	61,868	.02	ad hoc	8 yrs	No	Yes	59%
Oregon	$23 B	245,775	.0167	2%	5 yrs	Yes	Yes	100%
S. Dakota	$3.5 B	54,824	.01475	3.1%	3 yrs	No	Yes	124%
Utah	$8.7 B	122,832	.02	4%	N/A	No	Yes	98%
Virginia	$24.7 B	260,000	.0165	2.9%	5 yrs	Yes	No	74%

Upon comparing these numbers, one can arrive at some interesting general conclusions. Of the states listed, South Dakota has the fewest total members in its public employee retirement plan. Nevertheless, it does not have the least assets. In fact, of all fifty states, South Dakota boasts the highest assets as a percentage of projected benefit obligations. To put this statistic more simply, if a plan scores 100% in this area, it has exactly the amount of assets to pay for the amount of benefits expected to be paid out as time goes by. If it has a higher percentage, it has a surplus of funds. If its percentage is lower, its long-term liabilities outweigh its assets. In such states as West Virginia, where this percentage is 47%, sweeping reforms have been necessary to safeguard the pension system from actuarial disaster. What the statistic means for South Dakota, however, is that SDRS is on sound footing.

SDRS also boasts a low vesting period of three years, maintains a competitive cost of living increase, and offers a supplemental retirement option to its members. What the above chart does not show is the fact that not all states have viable survivor and disability plans for participants, as does South Dakota.

Some state retirement funds administer health plans as well (some also offer life insurance). In some cases (such as California) the retirement system administers the health plan for all employees. In other states (such as

Virginia) retirees have access to special health coverage funds paid by employers over time. In the case of Maine, the health insurance component is being discontinued.

Specific State Practices

Arizona--Immediate Vesting
Members of the Arizona State Retirement System become vested the day they start contributing to the system. This means that any participant may terminate employment at any point and still expect a benefit upon retirement. However, a participant must participate for at least five years in order to receive a benefit before age 65, or in order to qualify for health insurance premium benefits.

California--To the Extreme
Imagine a public employee retirement system which employs over 1,000 workers, maintains nine offices, has over one million members, and controls over $100 billion in assets. That's CalPERS, the California Public Employees' Retirement System. CalPERS has grown into a driving force behind the state economy, investing $13.9 billion within the state's borders annually. It has also become a one-stop shop for state workers, running a health maintenance organization for state employees, a long-term care program, a variety of death and disability benefit options, a home loan program, a deferred compensation program, and, of course, the retirement fund. CalPERS is the largest pension fund in the United States, and the third largest in the world.

Michigan--Defined Contribution is Required
As of this year, most new employees participating in the Michigan State Employees Retirement System will be required to take part in the state's defined contribution plan. This 401(k) plan will effectively replace the former defined benefit plan as the primary retirement plan for state employees. All new employees are required to participate, and all employees prior to May 1997 may switch to the new plan if they wish. In theory, the change will take a great deal of guesswork out of the state's retirement system, and add stability to actuarial planning. How effective the new plan will be is still quite uncertain, however.

Oregon--The Practice of "Picking Up"
In Oregon, the employee contribution rate for retirement is set in statute at 6%. However, few employees pay this contribution. The reason is a practice known as the "pick-up," whereby in lieu of a salary increase, the public employer pays for part or all of the employee's retirement contribution. This practice started in 1979, when the state's executive department agreed to "pick-up" the 6% contribution of certain classifications of employees instead of giving them an increase in salary. Over the years the practice has survived tests by the state supreme court and has spread to other participating units. In most cases, this practice saves the employer money in the end, since higher wages result in even higher employer contributions for Social Security, Medicare, insurance, and, of course, retirement. Through the "pick-up" all other factors remain the same for the employer.

CONCLUSION

Though public retirement systems may be seen as stable and unchanging entities, they are in fact very fluid in design. They grow, change, and at times falter from year to year. A solid knowledge of the concepts involved in public employee retirement is a must for any individual involved in state politics and financing, and for public employees themselves.

South Dakota public employees are fortunate to maintain a strong and responsive public retirement system. SDRS has grown and kept pace with many changes over the years since its founding. The great variety in public employee retirement systems nationwide, however, points to the fact that more changes can always be expected as time passes. Legislators and administrators alike must be knowledgeable and prepared to face these decisions as they arise, as the futures of many South Dakota citizens will always be at stake.

This issue memorandum was written by William E. Pike, Fiscal Analyst for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council.

[1] Due to extensive legislation passed during the 73rd Legislative Session, this report was revised on December 17, 1998 to reflect new laws and new actuarial and membership data.

[2] Please keep in mind that this survey was conducted in 1997. Only South Dakota's data has been updated to 1998.

[3] Taken from chart regarding assets as percent of obligations per state, from: Lemov, Penelope. "Michigan's Big Pension Gamble." *Governing*. May 1997, 41-43.

[4] Arizona maintains immediate vesting for its retirement plan members.