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**ISSUES CONCERNING OCCUPATIONAL SCHEMES FOR CIVIL SERVANTS  
AND OTHER PUBLIC SECTOR WORKERS**

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1. This document raises some policy issues regarding the pension plans of public sector workers, which may include workers employed by central, federal, and local governments as well as workers working for state enterprises. These plans may be classified as private or public depending on the legal nature of the institution responsible for administering the payment of benefits.

2. The objective of occupational schemes for public sector workers are generally the same as those for private sector workers. Indeed, in some countries, little or no distinction exists between them. Largely for historical reasons, however, public worker schemes in many countries often diverge from private sector pension practices and norms – particularly with respect to coordination and integration with national social insurance. In addition, public worker schemes are often financed with more reliance on “current disbursement” (PAYG) and less reliance on (advance) “funding.” The latter difference is not just a public finance issue; some public worker schemes pose political economy problems similar to those encountered with large reserves in basic social insurance regimes (and with provident funds).

3. The paper sets out some general policy issues with respect to public sector occupational pensions that may be further analysed by the Working Party. One issue of concern is the fact that these schemes exist in something of a standard-setting limbo. They do not fall clearly within the jurisdiction of the usual standard-setters for the private sector. Some countries, however, have chosen to apply the same legal framework to pension plans of both public workers and private sector workers (e.g. the civil servants' scheme in the Netherlands). Nor do they fall into the sphere of social insurance where the International Social Security Administration (ISSA) and other groups may choose to set standards (for example, with respect to investing the reserves of social insurance systems).

4. In the case of defined contribution (DC) arrangements, a reasonably strong case can be made that public sector worker DC schemes are essentially indistinguishable from their private sector counterparts. The Working Party may wish to suggest, therefore, that its principles and standards should apply to public sector arrangements in such cases.

5. In the case of public sector worker defined benefit schemes, however, much depends on the level of government, past financing practices, and delicate questions of fiscal and political federalism. But it might be possible to suggest minimum accounting practices to measure the cost of DB public worker schemes, standards that should attach in the event of any funding, governance rules, and rules addressing similar matters.

6. In both public worker DC and DB schemes, however, there is not only the issue of standards but also who supervises the application of those standards. It may be easy to say that private sector pension standards should apply to public sector pensions to some defined extent. It is another matter to say how supervision should take place.

7. A final point for deliberation is whether the Working Party on Private Pensions may wish to make recommendations about the integration of public worker schemes with overall social insurance systems in a country. Any activity along these lines would require collaboration with other OECD directorates (especially DELSA).

## **Background**

8. In many, if not most, countries, the creation of public service worker pension schemes – especially those for permanent civil servants – preceded the creation of general social insurance regime for old age, disability and death. Civil service reforms in the latter part of the 19<sup>th</sup> century created tenure protections (“dismissal only for cause”) to a cadre of permanent governmental employees. As some of these protected individuals reached relatively advanced ages (or became disabled, or left survivors),

government had to develop measures to “pension” them off.<sup>1</sup> Initially this was done by giving long-tenure older workers a relatively large percentage of their previous salaries, adjusted for expected work expenses, tax status, and similar matters. Overtime, these “superannuation” practices were formalized into final-pay defined benefit formulas, with some measure of final pay (e.g., last year, last three, last five), and accrual factor, which would yield pensions on the order of 55 to 80 percent for long-tenured workers.<sup>2</sup>

## **Integration and Coordination with Social Insurance**

9. Typically some years after the creation of civil service pensions, societies begin to enact more general state (“social insurance”) pension regimes, which are at inception often restricted to the urban employed. If the social insurance regimes are highly earnings-related, or they are differentiated into occupational sub-regimes, it is rare to find the antecedent civil service schemes “integrated” into the later enacted social insurance. At best, there may be some attempts at “coordination.”

10. A different pattern emerges if the social insurance regime starts out as either a contributory flat benefit (as in the basic pension in the UK and Ireland) or a non-contributory flat pension (volkspension or citizens pension as in north Europe). In these countries, earnings-related schemes subsequently develop, sometimes fully funded (Denmark and the Netherlands), sometimes PAYG or partially funded (Sweden), or a mix of the two (UK). Civil servants participate in both the first (basic pension) tier and have earnings-related pensions that are quite similar to those covering private sector workers (except for financing in some instances).

11. In countries where civil service pensions are not integrated with national social insurance, the role of civil service pensions (and other public worker pensions) becomes somewhat anomalous. Are they a subset of social insurance for some workers, or are these plans more like supplementary occupational schemes in the private sector that rest upon a base of first-tier social insurance? The borderlines become especially unclear in non-OECD countries with different pension schemes for different kinds of workers. That is, the central civil servants are covered in one scheme, local government workers by another, teachers by yet another, major parastatals have their own schemes, and there may or may not be a “general” scheme for those in the “formal” sector not otherwise funded.

12. Four factors generally argue for converting stand-alone public sector worker schemes into a combination of general social insurance coverage and one or more supplementary schemes for public workers that track the practices and norms of private sector schemes. Those factors are labor market flexibility, full accounting that reflects real social costs, problems with coverage gaps (especially for disability and death) and equitable sharing of the costs of the redistributive elements in social insurance. It is possible to develop coordination mechanisms that deal with at least some of these issues while leaving public sector workers' pension schemes intact, but these coordination provisions generally are second best solutions that leave loose ends.

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<sup>1</sup> A similar development is seen among academic institutions and financial market entities. See, for example, the history of the Carnegie pensions and TIAA-CREF pension fund in the US for academics. These are occupations where the work is “indoors with no heavy lifting” and staffed disproportionately by those with advantageous endowments. Not surprisingly, increasing life expectancies show up first among these populations. Further, there is an explicit and implicit understanding that the employment contract is permanent.

<sup>2</sup> Military, police and fire workers' pensions have a similar history, though in those cases, there is a perceived need to furlough most individuals relatively early in their lives.

## Regulation of Public Sector Workers' Pension Schemes

13. To what extent is it feasible or desirable to bring civil service and public worker schemes into the same regulatory ambit as private sector occupational schemes?

14. Defined Contribution Arrangements. Defined contribution plans present probably the easiest case. With the exception of French and French-derived repatriation defined contribution schemes, DC plans are generally funded with assets exterior to the employer under the management of an external asset manager. As in the private sector, public sector DC plans tend to take one of three paths in order to deal with the inherent instability of employers making investment decisions in DC plans. This instability arises because the results of these plans are borne by the workers, but there are no performance or benefit guarantees from the employer<sup>3</sup>.

15. The first is a DC plan with insurance elements (guaranteed return, death and disability provisions, some smoothing across cohorts) but in a framework in which the sponsoring employer(s) liability is understood to be fixed by a known and fixed contribution rate. In effect, the liability management responsibility is transferred to a third party. The Danish and Swiss occupational pension regimes are a clear example of this DC variant. The Danish scheme applies in the public sector as well as the private sector, and indeed the coverage expansion in Denmark over the past decades was initiated in the public sector.

16. Second, but similar to the first model are DC regimes in which, though performance guarantees as such are missing, the underlying portfolios are cautious and largely uniform, and there is generally no worker choice of portfolios. In some of these regimes, however, individuals often choose among different providers. This is model used widely in Latin America (and some Central and Eastern European countries). Except for the military, civil servants generally are treated much like any other citizen.

17. The third major path for DC schemes is to rest portfolio decision-making with participants. Countries come to this result by various means. In the UK, individuals choose their own personal pension providers (in stakeholder plans, they can cause their employers to hire one) and products. In the US, as in the private sector, the public sector has moved towards defined contribution plans with worker-directed accounts albeit often as schemes supplementing defined benefit arrangements.

18. The principal-agent issues are no different among schemes for public workers than private sector workers.<sup>4</sup> In general, the same standards can apply. Indeed, when the DC plans are maintained by inferior levels of government (provinces, lands, states, municipalities, special purpose public entities), it is technically feasible to submit such plans to the same national level supervisory agencies that have authority over private sector DC plans (or whatever type).

19. While feasible, however, such an assertion of jurisdiction might in certain cases run afoul of deeply held norms of “concurrent sovereignty” or “respective comity” or “subsidiarity” as between the highest (Federal or national) entity and the component units that derive powers separately from state or other electorates. In a few countries, these component units have distinct constitutions or basic laws. Can

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<sup>3</sup> Under the Working Party's taxonomy, plans in which the employer provides such guarantees are classified as defined benefit.

<sup>4</sup> It is also the case for DC plans that property rights are relatively straightforward. Once vested, a person has a legal or beneficial ownership right that looks very much like a bank deposit account, a collective investment scheme account, or an individual insurance policy with a savings component. That being the case, it is hard for governments to treat those moneys as “interior” to the governmental sector. With rare exceptions, DC accounts are treated as belonging to the household sector.

the national government, in the persons of its pension regulators (including the national legislature) and supervisor(s), regulate the employment practices of interior governmental entities in the latter's capacities as employers? Or does such regulation and supervision become so intrusive as to affect the constitutional autonomy of the sub-national polity?

20. Clearly, these issues affect more countries that have federal or federation structures (US, Canada, Australia, Brazil, Switzerland) than those with more unitary governments. The EU may have a parallel debate if it considers expanding private sector pension norms (or any other employment norms) to workers in the public sector.

21. A similar issue arises in the case of civil servant schemes in unitary governments or at the highest level of a federated government. It is sometimes difficult to apply exactly the same standards to the civil service schemes that apply normally to the private sector. Specifically, it may be difficult for an agency to regulate the pension activities of another body at the same level of government. For example, in the US, the 1985 reform of the Federal civil service system included the creation of the Federal Thrift Savings Plan – effectively it is a very large 401-k type plan for Federal government workers. Though bound to the same fiduciary (and reporting rules) as those enforced by the US Department of Labor, it is not subject to that Department's oversight, as such. In general, most of the tax rules applicable to analogous private sector plans apply, but some exceptions were made to prevent “disqualification” by reason of some of the so-called non-discrimination rules.

22. These examples may suggest that even in the easiest case of defined contribution plans a distinction needs to be made between public and private sector workers' pension plans. Is there something special about the government sector that requires different substantive standards? If not, is there something special that would nonetheless require a different approach to supervision?

23. Defined Benefit Arrangements. Defined benefit plans present even more complicated issues. Principal-agent issues involve also private sector workers who have a stake in defined benefit schemes for public sector workers because the state (ultimately taxpayers) guarantees pension benefits. The level of government at which regulation and supervision can be exerted is also sometimes a politically complicated matter. Can the “highest” sovereign always impose funding (and similar) rules on defined benefit plans maintained by “lower” levels of government?

24. Funding rules largely exist to ensure that pension promises are backed by adequate levels of assets. The protocols of the DB funding rules force recognition today of the costs of deferred compensation payable later in time. Funding – even in the form of explicit government debt only (discussed below) – can prevent provincial and national governments from making non-sustainable pension defined benefit promises to their own workers.

25. Funding rules also serve another purpose, namely to assure sufficient diversification of risk outside the employer<sup>5</sup> – is that a meaningful concept or necessity when it comes to governments? The more local or specialized the governmental entity – municipality, county, department, special purpose entity, public academic institution – the stronger the case for diversification through funding. In theory, the national or state government could stand behind the promises made by local entities and authorities, but

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<sup>5</sup> Arguments for funding, of course, often go beyond risk diversification needs or reifying accounting rules to achieve fiscal discipline. There are economic arguments for funding grounded in increasing national savings and creating more aggressive agents who allocate capital more efficiently. Economists, however, cannot not agree on how much funding in pensions adds to or substitutes for other household savings or how money wages adjust or not in light of funding or not. The capital market effects are even more debatable.

governments have been known to change their minds about unfunded pension promises when fiscal imperatives become acute.

26. The diversification argument to fund civil service DB schemes becomes less obvious if the scheme is maintained by the national government or by one of the primary constituent states within a federal structure. Even here the lack of funding may leave pensioners at risk. In both Brazil and Argentina, provincial governments have acquired non-sustainable levels of both explicit debt and implicit debt in the form of pension promises to past and current workers. The New York City fiscal crisis of the 1970s, which also affected New York State's debt position ultimately, had a significant pension element. Inevitably, the pension promises become part of the negotiation of what can be honored and what cannot.

27. Government activities and size ebb and flow over time not unlike private sector activities. Governments, most recently through accounting standards, long ago decided to protect private sector workers (and shareholders) from the myopia and hubris of the managers of large private enterprises inclined to assume market share dominance and their firms' immortality. By the same token, should government not also protect public sector workers (and taxpayers) from similar myopia and hubris within the public sector?

### **Issues in transition from PAYG to funded schemes in the public sector**

28. The principle of funding is easier stated than executed. Transition can be a major problem. What are the fiscal impacts of moving from "current disbursement" (or PAYG) financing to funding? The Commonwealth of Massachusetts would face major fiscal problems if it had to "fund up" the Commonwealth's many partially funded state and local pension schemes, except over a very long timeframe. Should lower level governments that have largely funded their pensions (e.g., the State of California) be subject to greater regulatory scrutiny than those that have not engaged in advance funding?

29. At the highest level of government all the above issues exist, plus there is the added problem that full funding of the national government's civil service defined benefit scheme would imply that an entity of, or at least associated with, the national government would hold a large amount of marketable assets. In defined contribution plans, this political economy problem is often finessed through delegating portfolio choice to the workers (or a third party in an insurance style scheme) and assuring, as necessary, an expanding number of service providers. Workers directly "own" defined contribution accounts and likely are able to exercise enough political power to keep "management" (that is, the political authorities) from exercising control over their moneys. This is especially the case if the country has in place strong norms for private sector defined contribution plans that can be appealed to.

30. The liabilities of national defined benefit schemes for public workers can be easily amount to some 10 to 20 percent of annual GDP. Though modest in comparison to the liabilities of most general social insurance programs (100 to 300 percent of GDP), backing these public worker DB schemes pose the same challenges as "partial funding" a substantial fraction of social insurance liabilities (sometimes called a "buffer fund," premium-scale financing, and similar terms).<sup>6</sup> Who would bear the burden of shifting from "implicit government bonds" (PAYG financing) to a portfolio of non-government marketable securities? If explicit debt were created to finance the transition, as a first order approximation, the private

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<sup>6</sup> Some countries avoid the political economy issues of advance funding social insurance by doing so solely in government bonds – for example, in 2011, the US social security trust fund is projected to be around 20 percent of GDP but, under current policy, held only in government bonds. While this achieve some future diversification in the tax bases financing benefits, it clearly does not diversify between the public and private sectors. And, holding everything else constant, if the trust fund were to invest in non-governmental bonds and equities instead, in general only a swap between the trust fund and private households' portfolios (with the latter holding more government bonds) would occur.

sector would end up holding more government debt (and less private sector debt and equity) in their pension and other household/corporate portfolios. Meanwhile the public workers pension fund could become possibly the single largest player in the country's capital markets.

31. In small countries, public pension schemes may want to consider investing in the debt and equity of other countries to the country-risk exposure of public sector workers just as similar investments by private sector pension schemes help protect private sector workers. It is harder, however, for public pensions to be seen a hedging against their own countries. In addition, in the case of developing countries, the macro-economic implications would have to be weighed, particularly in those countries without any significant FDI influxes. The question also has to be asked in lower income countries with low pension coverage is whether minimizing country-risk for civil servant pensions is so important that the country has to take on more external debt to accomplish the goal?

32. In larger, developed countries, these diversification arguments are relatively weak, and without a corresponding contraction in consumption (and increase in net national savings), the act of funding public worker DB pensions would have no effect on the nation's capital stock. Effects on domestic capital markets would depend on how the asset management in the DB plans was handled – one can envision scenarios ranging from slightly positive to neutral to inappropriately intrusive.

33. Unfortunately, as noted earlier, not having funding in public worker DB plans creates the incentive for politicians to underpay public workers in current compensation in return for very generous pensions, the costs of which are pushed down the fiscal road to some future generation of politicians and taxpayers. Remedying that situation demands measures that go beyond the bounds of pension regulation and supervision. Usually public worker compensation has to be completely recalibrated to fit good private sector practices, including the "typical" pension package. To the extent that a DB pension continues to be part of the pension package and to the extent it remains largely funded in "implicit" bonds, two steps can be taken short of conventional funding.

34. One is a slow multi-year move from implicit debt to explicit government bonds backing the liabilities of the civil service pension scheme. The second is to introduce full accrual cost accounting for pension accruals within the governmental budgeting process. This internal cost accounting, if enforced, can affect management decisions at the agency level within the government, including the trade-off between the number of workers and the cost of compensation per worker. Both of these measures have been undertaken by the U.S. Federal government to give a complete accounting recognition of its liabilities for both the old and new civil service defined benefit schemes.