

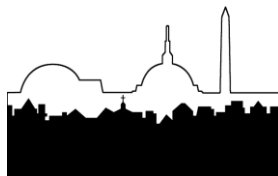
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DC APPLESEED CENTER REPORT

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THE DISTRICT OF COLUMBIA'S PENSION  
DILEMMA—AN IMMEDIATE AND LASTING  
SOLUTION

June 26, 1996



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**THE DISTRICT OF COLUMBIA'S PENSION  
DILEMMA -- AN IMMEDIATE AND LASTING  
SOLUTION**

June 26, 1996

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## **EXECUTIVE SUMMARY**

The District of Columbia government faces many financial difficulties, but none is more grave and less understood than the mushrooming unfunded liability of the pension plans that cover its police officers, firefighters, teachers, and judges (“the Plans”). This liability currently stands at \$4.7 billion and is growing at the rate of several hundred million dollars a year. Make no mistake about it—even if the District were to solve all its other financial problems overnight, this one problem is large enough by itself to ensure that the District will never emerge from its current financial crisis and that, in fact, the crisis will deepen with each passing year. This Report proposes a simple and sound resolution: that the entire \$3.6 billion in pension assets the District has accumulated since 1979 be transferred to the Federal government, and that the Federal government assume the liability of paying retirement benefits to the Plans’ participants.

The source of the District’s unfunded pension liability lies in how the Plans were transferred from Federal to District responsibility in 1979, shortly after Home Rule was established. Congress created the police officers and firefighters’ plan in 1916, the teachers’ plan in 1920, and the judges’ plan in 1970. Over the years, the District government and the Plans’ participants made contributions to the Plans, which were not invested in a separate trust to pay future benefits but, instead, were deposited directly in the general fund of the United States Treasury, and used to pay the Federal government’s general operating expenses. In exchange for immediate unrestricted use of Plan contributions, the Federal government promised to pay the benefits due Plan participants when they retired. When retirement benefits came due, the Federal government simply paid them with unrestricted funds drawn from the Treasury’s general fund, so

that the practical risk that participants would not receive their promised benefits was virtually non-existent.

This arrangement might have remained in place indefinitely without incident, since it is identical to the arrangement under which the main Federal civil service and military pension plans continue to operate today. However, in 1979, the Federal government relinquished its responsibility to make retirement benefit payments to the Plans' participants and transferred liability for the Plans to the District. Congress did not leave the District totally empty-handed. To help defray the pension liability the District had assumed, the Federal government immediately transferred \$38 million to the District and promised to pay an additional \$52 million a year for the next 25 years. At the time, this stream of promised Federal payments had a then present value of \$649 million.

The problem with the 1979 transfer was that the pension liability shifted to the District far exceeded the \$649 million value of the promised Federal payments. In fact, as of 1979, the Plans' liability for service performed by participants before the transfer occurred had a then present value of \$2.7 billion. Thus, the District was left with over \$2 billion in pension liability for which the Federal government accepted no responsibility. This occurred even though the District government and Plan participants had for decades turned over their own contributions to the Federal government with the understanding that the Federal government would later pay the benefits due when participants retired.

Because of the underfinancing in 1979, the unfunded liability has grown to \$4.7 billion in 1995. Based on sound actuarial assumptions, it is estimated that \$2 billion should have been added to the Plans' Retirement Fund in 1979 to ensure that the Plans could pay projected future

retirement benefits. Each year that the Plans remain underfinanced, investment income is lost, resulting in an increase in the unfunded liabilities. Thus, the unfunded liability has grown to its current level and is expected to reach \$7 billion in 2004. It will continue to grow unless sums adequate to meet the unfunded liability are paid into the Plans from some source.

It is important to note that the District has fully funded all benefits that participants have earned since the 1979 transfer of liability. Every year since then, the District government and Plan participants have made contributions to the Plans that have more than covered the costs of the benefits that participants earned in that year. Indeed, the excess contributions made by the District have reduced the rate of growth in the unfunded pension liability inherited from the Federal government. Otherwise, the District's unfunded pension liability would be even larger than it already is today.

In addition to these steps taken by the District on the funding side of the Plans, following Home Rule the District moved aggressively in cooperation with Congress to reduce the unnecessary liability imposed on the Plans by unsubstantiated claims for disability retirement benefits for police and fire personnel, which were rampant during the period of Federal control before Home Rule. As a result of the District's efforts, disability retirement rates were reduced from roughly 98 percent in 1969 to less than 4 percent today.

Unfortunately, these steps have not solved the problem. Today, the unfunded pension liability saps the District of needed revenues and restricts the District's borrowing capacity and the repercussions are increasing. In 2004 -- a mere eight years from now -- the unfunded liability will have grown to \$7 billion, at which time Federal law will require that the District make payments of \$490 million dollars every year forever just to keep the unfunded pension liability from

growing even more. Something must be done now to eliminate the impact of the unfunded liability on the District's already tenuous financial condition and to ensure that participants covered by the Plans will receive their promised payments.



Because the unfunded liability (\$4.7 billion) is now about the size of the entire annual District budget (\$5 billion), the Federal government is the only entity capable of taking financial responsibility for the Plans' underfunding. There are two basic options.

First, several legislative and policy proposals advocate increasing the annual Federal pension contribution over the next 40 years, thereby slowly decreasing the unfunded liability. Unfortunately, such proposals would not soon eliminate the effects of the unfunded liability on the District's budget or borrowing capacity. Furthermore, to pay the full amount of the unfunded liability, Congress would have to appropriate over \$300 million each year for 40 years. Given today's Federal budget deficit, such an extended commitment appears uncertain, particularly in light of the fact that in future years Congress may forget that these contributions are merely the reversion over time of liability created by the Federal government.

In this Report, D.C. Appleseed proposes a second option that is effective, equitable, and enduring. We recommend that the \$3.6 billion in pension assets the District and participants have built up be transferred from the District to the Federal government, and that Plan participants and liability be returned to the Federal government. The transfer of pension assets could be accomplished in a variety of ways, including a lump sum transfer or the creation of a trust fund that would generate earnings dedicated to paying retirement benefits assumed by the Federal government. The concurrent elimination of unfunded liability on the District's books, and the cessation of overpayments by the District will profoundly ameliorate the District's fiscal crisis, thereby reducing both local and Federal concerns that the District will need to be bailed out in the future. District employees covered by these Plans would receive a reliable guarantee of payment from the Federal government rather than from the financially shaky District government.

This proposal is fair to the Federal government. While it will require the Federal government to reassume responsibility for the unfunded liability, which will be paid out over many years, it will also immediately provide the Federal government with \$3.6 billion in assets. About half of this \$3.6 billion represents overpayments the District has made into the Plans over the past 16 years. This asset transfer will not only temper the long-term liability accepted by the Federal government, but will also ameliorate the potential political perception that Congress is handing out money to the District.

D.C. Appleseed's proposal will require that the District, in addition to transferring all of the Plans' current \$3.6 billion in assets, establish new pension plans for police officers, firefighters, teachers, and judges hired after the transfer. Although the design of the new plans could be the same as or different from that of the current Plans, the District must safeguard against the creation of any significant unfunded liability in the future, to ensure that the District's fiscal condition is stabilized.

Resolution of the District's pension liability crisis alone will not solve the District's numerous financial and operational problems. However, it will be a big help, and police officers, firefighters, teachers, and judges deserve the security of knowing that their pension benefits are sound. Given the magnitude of the current effects of the unfunded liability on the District and the impending crisis for pensioners covered by these Plans, a solution must be adopted soon. The transfer of assets and liabilities we propose in this Report is an answer which is equitable, comprehensive, and lasting.

# **THE DISTRICT OF COLUMBIA'S PENSION DILEMMA: AN IMMEDIATE AND LASTING SOLUTION**

## **INTRODUCTION: A DILEMMA THAT WILL NOT DISAPPEAR**

What has \$3.6 billion in assets, receives more than \$300 million from the District of Columbia and \$52 million from the Federal government every year, pays out far less than it takes in, yet is hopelessly insolvent? The District's three pension plans for police officers/firefighters, teachers, and judges (the "Plans"), which cover one out of every three current District employees.

The reason for this seeming paradox is easy to identify: the Plans do not have enough money set aside to meet their obligation to pay future retirement benefits. Specifically, the Plans currently have \$3.6 billion in assets, but would need \$8.3 billion today in order to meet their entire future liability to Plan participants. Thus, the Plans now have a staggering unfunded liability of \$4.7 billion which is growing daily.

The root cause of the underfunding is clear. The Federal government failed to assure adequate financing when it transferred the Plans to the District government in 1979. Specifically, the Plans were underfinanced by \$2 billion at that time and, as a direct result, the Plans' unfunded liability has reached its current crisis proportions.

Understanding the reason why the Plans' unfunded liability has increased from \$2 billion in 1979 to \$4.7 billion in 1995 is critical to understanding the consequences of failing to solve the unfunded liability problem immediately. The \$2 billion unfunded liability in 1979 is a retrospective estimate, using sound actuarial assumptions, of what should have been added to the Plans' Retirement Fund in that year to produce sufficient investment income to ensure that the Plans could pay projected future retirement benefits. However, the hypothetical \$2 billion was

not added to the Retirement Fund in 1979, and thus no investment income has ever been earned on it. This lost investment income, referred to as “interest on the unfunded liability,” increased yearly, expanding the unfunded liability. Thus, even though substantial contributions have been made to the Plans,<sup>1</sup> the unfunded liability grew to \$4.7 billion as of September 30, 1995. This liability will continue to grow until the unfunded liability is paid into the Plans from some source.<sup>2</sup>

If this pattern continues, the Plans eventually will be unable to pay out the retirement benefits they owe, or the District will crumble financially in a futile attempt to fund the Plans adequately. Thus, unless something is done, the Plans will sink into an accelerating downward spiral and drag the District down with them. Regardless of why the problem has reached its current proportions, a lasting, viable solution must be implemented soon because the financial consequences of not doing so are immense and worsen daily.

Certainly, there are many problems the District’s government and citizens must resolve, but the pension crisis cannot be solved by the District alone. The best solution to the pension problem is to return the liability for the Plans from the District to the Federal government, which established the Plans and is responsible for their underfunding. Moreover, the Federal government is the only entity financially able to assure that those covered by the Plans receive the pensions for which they have worked so long and which were promised to them.

For its part, the District should transfer all of the \$3.6 billion in assets the Plans have

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<sup>1</sup> For example, in 1995, the Plans received \$871 million, consisting of \$483 million in investment income, \$336 million in contributions from the District government and participants' withholdings, and \$52 million from the Federal government. See Exhibit 1 - “Analysis of D.C. Retirement Board Financial Data - 1979-1995.”

<sup>2</sup> For purposes of clarity to a broad audience, the description in this paragraph differs from the way actuaries would describe the growth of unfunded liabilities.

accumulated since the District was given responsibility for the Plans in 1979, and will have to establish new pension plans for police officers, firefighters, teachers, and judges who are hired after the Plans are transferred back to the Federal government. While the scope of coverage and level of employee and District contributions to the new plans will depend on a variety of factors, it is imperative that the District ensures that there is no chance that a similar massive unfunded liability will reappear and, therefore, should consider whether to put new hires in a type of plan that will avoid the funding problems previously encountered.

Section I of this Report reviews the history leading to the large current unfunded liability. Section II describes possible courses of action, including H.R. 3389, which was introduced in the U.S. House of Representatives by D.C. Delegate Eleanor Holmes Norton in May 1996. Section III presents the details of D.C. Appleseed's proposal and discusses its benefits and costs.

For simplicity, this Report refers to the three separate Plans for police officers/firefighters, teachers, and judges collectively as the "Plans," and to those who are covered by them as the "participants." We recognize that each Plan covers a different group of employees and has significantly different features, such as eligibility criteria and retirement ages. While those differences have been factored into the figures in this Report, the Plans are treated together because their similarities predominate for purposes of the issues covered in this Report.<sup>3</sup>

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<sup>3</sup> Exhibit 2 - "Details on Provisions of the Three District-Administered Pension Plans" - contains a summary of the relevant provisions of the three individual Plans.

## **I. BACKGROUND: CREATION AND SCOPE OF THE PROBLEM**

### **A. Some Basic Principles of Pension Finance**

Although numerous varieties of employer-provided pension plans exist in the private sector, there are two basic types: "defined contribution" plans and "defined benefit" plans. Under a defined contribution plan, the employee and/or employer make contributions to the plan on the employee's behalf, and the contributions are then invested. Upon retirement, and in some cases earlier, the employee is entitled to receive the value of all principal contributions and net earnings on them. The distinguishing characteristic of defined contribution plans, therefore, is that the benefit to which the employee is entitled is based solely on the amounts contributed to the plan on the employee's behalf and net earnings on those contributions. Thus, defined contribution plans are, by definition, fully funded.

By contrast, the benefit promised to an employee under a defined benefit plan is calculated wholly apart from the contributions and net earnings actually received by the plan, and usually represents a specified percentage of the employee's salary during specified years of service. For example, a simple defined benefit formula might provide that, upon retirement, an employee will be entitled annually to 1 percent of the employee's average salary over the last three years of employment, multiplied by the number of years of service with the employer. Therefore, in order to fund a defined benefit plan fully, the employer must make contributions (sometimes supplemented by employee contributions) to the plan that, when added to the projected net earnings on those contributions, will be sufficient to satisfy the benefits payable under the plan's formula. The amount that must be contributed in any given year to keep a defined benefit plan fully funded is dependent on a variety of factors -- for instance, the investment performance of existing assets, assumptions about how long employees will work and live, and other assumptions

about future interest rates, benefit enhancements, and employee salary increases. If a defined benefit plan becomes less than fully funded, the shortfall will tend to increase over time because the plan will not achieve the assumed earnings of a fully funded plan.

The principal Federal law governing employee pensions, ERISA,<sup>4</sup> bars private employers from underfunding defined benefit plans. However, no such rules apply to government plans. Nonetheless, many state and local employers soundly fund their defined benefit pension plans, while a few pay current retirement benefits out of their general revenues without making adequate contributions into their pension funds to pay their ultimate pension liabilities. This funding approach, sometimes loosely termed "pay as you go," does not fully fund retirement benefits as they accrue over an employee's working life, thereby exposing the governmental employer to potentially large future expenses for which no reserve has been established.

**B. Federal Control Prior to Home Rule: 1916 - 1975**

The District's unfunded pension problem began long before the establishment of Home Rule in 1975. Between 1916 and 1970, Congress created the three Plans and defined the participants' benefits.<sup>5</sup> The Plans were created as defined benefit plans that promised to pay participants a lifetime annuity without regard to how much money had been set aside to fund these benefits -- a plan design that resembled the majority of public sector retirement plans at the time.

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<sup>4</sup> Employee Retirement Income Security Act, Pub. L. No. 93-406 (1974), 29 U.S.C. secs. 1001-1461 (1995), commonly referred to as "ERISA."

<sup>5</sup> U.S. General Accounting Office, "District Pensions: Federal Options for Sharing Burden to Finance Unfunded Liability" (Dec. 1994) (GAO/HEHS-95-40) at 16 n. 9 (hereinafter "1994 GAO Report").

As established by Congress, the Plans had unusually high costs for a number of reasons, two of which are worth noting:

- Disability Retirements: The police officers/firefighters plan provided that the Board of Police and Fire Surgeons would certify when individual police officers and firefighters were eligible for tax-free early retirement benefits on account of disability. Inadequate oversight of the Board of Police and Fire Surgeons led to an excessive number of disability retirements. As a result of the large number of early retirees, retirements were longer and the benefits ultimately payable increased significantly.<sup>6</sup>
- COLAs: Both before and after the institution of Home Rule, the Plans provided for twice-a-year cost-of-living adjustments (“COLAs”), an unusually generous form of indexing retirement benefits for inflation.<sup>7</sup>

Prior to the establishment of Home Rule in 1975, employees and the District government both contributed to the Plans, but those contributions went into the Federal Treasury rather than into a separate pension trust fund dedicated to providing benefits to participants. As a result, contributions to the Plans were spent by the Federal government to fund Federal operations, benefits were paid each year from available Federal Treasury general revenues, and almost nothing was set aside to pay the future benefits participants were earning year by year.

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<sup>6</sup> Excessive disability retirements were at their worst prior to Home Rule in 1975, and have been brought into check by the District government. According to the U.S. General Accounting Office, “(1) in 1969, of the total number of retirees, 99 percent of firefighters and 98 percent of police were retired on disability, and (2) in 1977, 63 percent of firefighters and 52 percent of police retired on disability.” 1994 GAO Report at 16 n. 9. In 1995, less than four percent of all police and firefighters retired on disability. D.C. Police and Firefighters Retirement and Relief Board, Optional and Disability Retirement Calendars, 1967-1995.

<sup>7</sup> Over the years, these twice-a-year COLAs escalated the participant’s retirement annuities, thus increasing the accrued unfunded liability. However, the COLAs were not literally doubled, but instead accelerated slightly as the result of their twice-yearly calculations. According to the D.C. Retirement Board, in a change effected via annual congressional Appropriations Acts, this practice ceased for employees retiring on or after January 1, 1980. Thus, since 1980, only participants who retired prior to 1980 receive twice-a-year COLAs, while all other retirees receive one annual COLA.



This was the standard “pay as you go” practice at the time for funding other Federal pension plans: retirement contributions were collected and retirement benefits were paid, but there was no logical correlation or nexus between the amounts contributed and the amounts paid.<sup>8</sup> As a result, even when compared to significantly underfunded state and local plans, the District Plans became egregiously underfunded.

The fact that District employees participating in the Plans were subject to the same arrangement as Federal employees was not unusual in light of the status of the District at the time. Prior to Home Rule, the District government was treated as though it was a small Federal agency. All of the Plans’ participants, who were working for the District of Columbia, were on the Federal payroll: there were no independent District of Columbia bank accounts; all taxes and other revenue, even those payable to the District, were deposited in the Federal Treasury; and all District payments to vendors, creditors, and others were paid with checks from the Federal Treasury.

**C. Transfer of the Problem to the District Following Home Rule: 1975-1979**

Home Rule for the District became effective on January 2, 1975.<sup>9</sup> Nonetheless, through 1979, contributions to the Plans by the District and the Plans’ participants continued to be deposited in the Federal Treasury. A report prepared by Arthur Andersen & Co. in 1976 for the United

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<sup>8</sup> Indeed, this continues to be the Federal government’s current practice for most of its defined benefit plans. However, this funding practice was unlike that for most non-Federal pension plans, which specifically set aside employer and employee contributions that, together with investment income, were designed to be sufficient to fund future benefit obligations as they become due.

<sup>9</sup> The District of Columbia Self-Government and Governmental Reorganization Act, Pub. L. No. 93-198 (1973) (hereinafter the “Home Rule Act”) prospectively established Home Rule beginning in January 1975.

States Senate showed that the Plans had an unfunded liability of approximately \$2 billion.<sup>10</sup> Because the Federal government took no steps to reduce the liability that had accrued before Home Rule, the total unfunded liability increased from \$2.0 billion in 1975 to \$2.7 billion in 1979.

Congress passed legislation in 1978 that would have provided a Federal contribution to the Plans of \$65 million per year for 25 years.<sup>11</sup> This series of contributions would have paid off the unfunded liability for those participants who had retired prior to Home Rule. However, the legislation would have done nothing about the bulk of the unfunded liability, which was attributable to retirement benefits promised by the Federal government to then current employees for work performed for the District before Home Rule.

President Carter vetoed even this modest measure on the ground that the Federal government was being asked to pick up more than its share.<sup>12</sup> Given the Plans' history, it is difficult to understand how the President concluded that the Federal government was not responsible for most, if not all, of the unfunded liability. Specifically, President Carter ignored the fact that the District was under the complete control of the Federal government and its appointed administrators prior to Home Rule, when nearly all of the Plans' liability was created.

In 1979, Congress passed and President Carter signed the District of Columbia Retirement Reform Act, which (1) transferred the \$2.7 billion liability for the Plans from the Federal government to the District, (2) required the Federal government to pay the District \$38 million in

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<sup>10</sup> "Report to the U.S. Senate Committee on the District of Columbia on the Accounting and Financial Management Practices of the District of Columbia Government," Arthur Andersen & Co. (June 1976), Vol. 1, Exec. Summary at 8 (hereinafter the "Andersen Report").

<sup>11</sup> 1994 GAO Report at 3.

<sup>12</sup> 1994 GAO Report at 17.

net assets then in the Plans' funds, and (3) obligated the Federal government to pay the District \$52 million yearly for the ensuing 25 years, through 2004.<sup>13</sup> Thus, the Retirement Reform Act transferred the Plans' entire liability to the District but promised the District a total of only one-fourth of the Plans' unfunded liability. Specifically, the Federal government transferred \$38 million in assets to the District, far less than the Federal government had collected from active participants and the District. More importantly, in 1980, when the first \$52 million annual Federal contribution was made, the present value of the 25 yearly Federal contributions was only \$649 million.<sup>14</sup> Thus, the Federal government promised to transfer to the District a total of \$687 million, while the Federal government should have transferred \$2.7 billion to the District in 1979 to meet the obligations to participants that had accrued while the Federal government had control over the Plans.<sup>15</sup> As a result, the District assumed \$2 billion in unfunded liability.

The transfer of the Plans to the District had profound consequences to Plan participants. Prior to the transfer, participants received a Federal guarantee that, when they retired, they would

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<sup>13</sup> District of Columbia Retirement Reform Act, Pub. L. No. 96-122 (1979) (hereinafter "Retirement Reform Act").

<sup>14</sup> See "District's Pensions: Billions of Dollars in Liability Not Funded," U.S. General Accounting Office (Nov. 30, 1992) (GAO/HRD-94-18) at 5 (hereinafter "1992 GAO Report"). The \$52 million annual Federal contribution was calculated as the amount needed to fund 80 percent of the retirement benefits, and 33 percent of the disability benefits, of participants who were already retired at the time of Home Rule. Significantly, the \$52 million Federal contribution was not designed to cover any portion of costs needed to pay for the retirement of those employees hired before Home Rule who continued to work thereafter, including the participants' contributions withheld and deposited into the Federal Treasury during the period of complete Federal control. Thus, if a police officer worked 19 years and 364 days before Home Rule, worked one day after Home Rule, and then retired, the retirement benefits covering that officer's entire 20 years service would be borne solely by the District.

<sup>15</sup> See Exhibit 3 ("Memorandum - Unfunded Liability" column).

receive retirement benefits from the Federal Treasury. Therefore, the risk to employees participating in the Plans was minimal. However, following the transfer, in place of the Federal government's guarantee to pay their pensions at retirement, participants received a "guarantee" of retirement benefits from the District. But, while the Federal government had paid participants' retirement benefits from the vast revenues of the Federal Treasury, the District's pension obligations could be satisfied only out of the hopelessly underfunded Plans or the District's own limited revenues.

Perhaps the prospect of even limited Home Rule -- after nearly 100 years of Federal control -- prevented District officials and citizens from confronting the magnitude and implications of the unfunded pension liability problem.<sup>16</sup> In fact, such an unfunded pension liability transfer would be prohibited by ERISA if it involved employers in the private sector. To say that District residents should have been "wary of Federal agents bearing Home Rule" is a colossal understatement.<sup>17</sup>

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<sup>16</sup> The underfunding problem was disregarded in the transition to Home Rule even though a host of studies addressed the issue. See reports cited in Andersen Report, Vol. IX - Retirement Systems, at 11-17. These reports included the 1972 report by the Nelsen Commission, a well-respected bipartisan study group appointed by Congress which reported that the police/fire and teacher plans were "not currently financed on a sound actuarial basis [because] ... [t]he present level of unfunded accrued liabilities is dangerously high [and] ... [t]here are no plans for either curtailment of the rate of [their] increase ... [or] for their systematic reduction or amortization." H. Doc. No. 92-317, at 533-34.

<sup>17</sup> The Federal contribution to the Retirement Fund enacted in the Retirement Reform Act should not be confused with the annual Federal Payment to the District's General Fund. The annual Federal Payment is unrelated to pension liability issues, but rather is intended to compensate the District for added costs and foregone revenue due to the Federal government's presence in the District. For a discussion of the Federal Payment, and related issues, see the D.C. Applesseed Center's Report "The Case for a More Fair and Equitable Federal Payment for the District" (Nov. 1995).

#### D. **Growing Liabilities and Legislative Inaction: 1980 - Present**

When the Federal government started paying its \$52 million a year in 1980, the District began making payments into the Plans' newly-created Retirement Fund pursuant to a formula mandated by Congress in the Retirement Reform Act.<sup>18</sup> Under that formula, the District's 1995 contribution to the Plans was \$298 million, not including participants' contributions.<sup>19</sup> The District's payment alone far exceeded the amount needed to pay the cost of benefits earned by Plan participants for their service in each year, referred to as the "normal costs," which was \$136 million in 1995.<sup>20</sup>

Despite the District's payment of more than normal costs, the effects of the initial Federal underfunding persist, and the unfunded liability has grown. Although net assets of the Retirement Fund now total \$3.6 billion, the Retirement Fund needs about \$8.3 billion to meet its actuarially determined obligations. Thus, there is now an unfunded liability of approximately \$4.7 billion. Under present circumstances, even though the District is fully paying the normal cost of the Plans, the unfunded liability continues to grow because the amounts being paid into the Retirement Fund

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<sup>18</sup> The formula requires the District to pay yearly (1) a small amortized portion of the interest accruing on the unfunded liability, and (2) the lesser of (a) pay as you go or (b) normal cost plus projected interest. Payments under the formula would never reduce the original \$2 billion unfunded liability transferred to the District nor prevent it from growing. Retirement Reform Act, Sec. 142, 93 Stat. 866, 877-81 (1979); see also 1992 GAO Report at 3.

<sup>19</sup> See Exhibit 3 ("District's Contributions to Plans" column).

<sup>20</sup> "Normal cost" is defined as the amount that must be paid into a pension plan each year to pay the present value of the increase in future pension payments attributable to that year's employment of the plan participants. For an adequately funded plan, normal cost is simply that amount that in a single year, given expected earning investment and actuarial assumptions, must be invested to meet participants' entitlements based on that year's service when they retire. See Exhibit 2 to this Report for data on the Plans' normal costs and contributions to the Plans.

over normal cost is not sufficient to cover the interest on the unfunded liability resulting from the original shortfall in funding inherited from the Federal government in 1979.<sup>21</sup>

Under the Retirement Reform Act, Federal government contributions to the Retirement Fund terminate in 2004 and the formula governing the District's payments also will change. Specifically, the District's Federally mandated annual payments to the Retirement Fund commencing in 2005 will equal the sum of (1) the net normal costs of the Plans and (2) the interest on the unfunded liability, representing the foregone investment income for that year resulting from the Plans' unfunded liability. The Retirement Reform Act does not, however, require the District (or any other entity) to pay down the unfunded liability itself.<sup>22</sup>

The alarming portion of this formula is not the payment of normal costs; the District now pays and should continue to pay the Plans' normal costs to ensure that they are soundly funded. Instead, the Retirement Reform Act will financially debilitate the District because it requires that the District pay a fixed and substantial amount of lost investment income -- or interest on the unfunded liability -- every year forever. Specifically, because the underfunding is expected to be at least \$7 billion in 2004, the District would have to pay approximately \$490 million into the Retirement Fund yearly, assuming a modest investment rate of 7 percent, just to freeze the unfunded liability at \$7 billion. This payment represents 10 percent of the District's entire General Fund expenditures for fiscal year 1996. Because the Retirement Reform Act does not provide any mechanism for reducing the \$7 billion unfunded liability itself, \$490 million of

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<sup>21</sup> See page 2 for a discussion of "interest on the unfunded liability."

<sup>22</sup> If the District paid down the unfunded liability using a reasonable amortization of 20 years, the District would have to pay into the Retirement Fund \$350 million every year from 2005 through 2024, in addition to paying the Plans' normal costs, and interest on the unfunded liability.

investment income will be lost every year. Thus, in addition to paying the Plans' normal costs, the \$490 million annual payments required of the District will continue *ad infinitum*.

In sum, the initial unfunded liability transferred to the District in 1979 has created an enormous financial burden on the District. Without this liability, the annual cost of the Plans to the District would have been only \$136 million in 1995, which, together with participants' contributions, would allow the District to pay participants' retirement benefits fully without any supplement from the Federal government. In fact, however, the District paid well over twice that amount in 1995 -- about \$298 million.<sup>23</sup> The excess of actual payments over normal costs -- about \$162 million -- represents the District's overpayment caused by the Federal government's underfunding in 1979. In contrast the Federal Government paid only \$52 million into the Plans' Retirement Fund in 1995, about one-sixth of the District's contribution.<sup>24</sup>

Today, the most critical fact is that, if the problem is not addressed and resolved now, the \$490 million above normal costs that Federal law requires the District to begin paying in 2005 will swamp the District, equaling 10 percent of its current General Fund expenditures of \$5 billion.<sup>25</sup> Something must be done before then, and, because the unfunded liability grows daily, action

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<sup>23</sup> This figure reflects the District's contribution alone, and does not include participants' contributions. See Exhibit 3.

<sup>24</sup> Another way to look at the situation is to compare pension costs to annual salaries. The \$298 million currently paid by the District represents 82% of the salaries of the four employee groups covered by the Plans, a figure that could leap to over 300% of payroll in the year 2005 if the current Retirement Reform Act formula continued to be applied. D.C. Appleseed knows of no other pension plan that has annual costs even close to annual payroll, let alone three times that amount.

<sup>25</sup> See Exhibit 3 for a comparative analysis of pension benefits, participants, and actuarial assumptions for the various District employees covered by the three pension plans.

should be taken soon.



## II. OPTIONS

There are few choices available to the District and the Federal governments, and none is attractive.

### A. The Treacherous Status Quo

The Federal government could do nothing until 2004, when Federal contributions cease. However, the status quo inevitably throws a cloud over the payments that participants are entitled to receive. Whatever their legal or contractual rights, participants can take little comfort in the knowledge that their only claims are against an entity, the District, that has no means -- other than the Federal government -- to pay them. The status quo is unfair to these employees.

And, the problem is worsening rapidly. With each day of delay, investment income is lost as a result of the unfunded liability, and that lost investment income is added to the principal amount of the unfunded liability on which yet further investment income is lost.

The stream of enlarged payments the District must now pay into the Plans, coupled with the unfunded liabilities on its books, exacerbates the District's current weak financial condition. The \$162 million or more that the District must pay each year above "normal costs" diverts money desperately needed to reduce the deficit and provide essential services to District residents. It also damages morale and performance of District employees and contributes to the exodus of residents from the District, further diminishing its tax base. By aggravating the District's deficit, this excessive pension payment has a negative effect on the District's ability to raise money at reasonable rates (if at all) in financial markets.<sup>26</sup>

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<sup>26</sup> The District's debt is already rated at "junk bond" status, and the capital markets for the general obligation debt are essentially no longer available to the District. Any borrowing from the Federal government, if permitted, would be at taxable prevailing rates, which are 1 to 3 percent

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higher than non-taxable “municipal” rates.

Finally, if nothing is done before 2004, the District will be required to pay the Federally mandated \$490 million yearly payments above and beyond the Plans' normal costs, a payment that will undoubtedly prevent the District from achieving or maintaining financial solvency. The specter of the Federal government doing nothing to remove the tarnish on our national capital has adverse implications that are difficult to quantify but are very real. So far as we know, no other modern industrialized country has allowed its national capital to sink into bankruptcy.<sup>27</sup>

**B. Increasing the Federal Contribution and H.R. 3389**

One possible solution is for the Federal government to increase its current payment of \$52 million to an amount necessary, and extend its payments for a period needed, to bring the Retirement Fund into balance. Doing that and nothing more would enable all retired and currently employed participants to continue receiving their retirement benefits as defined in the current Plans. Importantly, if implemented, such an alternative would move the Plans toward an actuarially sound basis by requiring that the Federal government and, perhaps to some small degree, the District government, assume all the risks and fully pay these obligations in the future.

This approach was embodied in H.R. 3389, introduced in the U.S. House of Representatives by District of Columbia Delegate Eleanor Holmes Norton in May 1996.<sup>28</sup> If enacted, H.R. 3389 would require the Federal government to make 40 annual contributions of \$295

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<sup>27</sup> Unlike all other municipalities in the United States, one avenue for relief for the District - bankruptcy -- is blocked off. The District is excluded from the definition of entities entitled to use Section 6 of the Bankruptcy Code for these purposes. 11 U.S.C. sec. 101(52). However, although the District cannot take advantage of Federal bankruptcy status, it certainly can be financially bankrupt, a status acknowledged by the market in rating the District's debt as "junk bonds."

<sup>28</sup> "District of Columbia Pension Liability Funding Reform Act of 1996," H.R. 3389 (104th Congress, 2d Sess.).

million each into the Plans' Retirement Fund beginning in 1997. Thus, H.R. 3389 proposes a significant increase in Federal responsibility for funding the Plans -- the present annual Federal contribution of \$52 million would be increased by 467 percent, and the Federal government's payment obligation, currently scheduled to cease eight years from now, would be extended by 32 years.

H.R. 3389 would simultaneously reduce the District's contributions to the Plans, replacing the District's formula-based contributions to the Retirement Fund,<sup>29</sup> currently \$298 million, with flat annual payments of \$185 million for 40 years beginning in 1997. Delegate Norton's proposal would also slightly increase participants' contributions to the Plans and modestly reduce the benefits of pre-1980 retirees. Specifically, the contributions of police officers, firefighters, and teachers would increase from 7 to 8 percent of salary and those of judges from 3.5 to 4.5 percent of salary, while COLAs for pre-1980 retirees would be reduced from twice to once yearly.<sup>30</sup>

If fully implemented, H.R. 3389 would be a vast improvement over the status quo. Most importantly, rather than allowing the Plans to continue on their present downward financial spiral,

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<sup>29</sup> See note 18 above for a description of the formula established in the Retirement Reform Act.

<sup>30</sup> As pointed out in note 7 above, the double COLAs for all other participants in the Plans were eliminated in the Retirement Reform Act. A proposal similar to H.R. 3389, the "Pension Liability Funding Reform Act of 1994," was introduced in the District of Columbia Council as Council Bill 10-515 in December 1993, and in the U.S. House of Representatives as H.R. 3728 in January 1994. The Council enacted its bill, which would have taken effect only if the House bill was enacted, but did not because H.R. 3728 "died" without action at the conclusion of the 103rd Congress. If enacted, H.R. 3728 would have continued the Federal contribution through 2035 and, beginning in 1995, increased the Federal contribution 5% annually for 40 years. In addition, District payments would have been reduced slightly from current projections, and recalculated to represent a fixed portion of payroll through 2035. In other respects, the two bills are very similar to H.R. 3389.

the payments required by H.R. 3389 from the Federal government, the District government, and participants are designed, in the aggregate, to fund the Plans fully by 2036. Additionally, by reducing the District's scheduled payments from their current inflated levels -- \$298 million and growing -- to a constant \$185 million, full implementation of Delegate Norton's proposal would free up more than \$110 million annually to help the District solve its financial crisis. By increasing Federal and decreasing District contributions to the Plans, H.R. 3389 would appropriately shift much of the burden for funding liabilities created before Home Rule to the Federal government, the only entity capable of curing the Plans' unfunded status. This transfer would reduce (but not eliminate) the impact of these liabilities on the District's capacity to borrow at reasonable interest rates.

Although H.R. 3389 is a principled proposal that, if fully carried out, would greatly benefit the District and Plan participants, it relies too heavily on sustained congressional action and, ultimately, does not go far enough. Initially, H.R. 3389 requires Congress to consent to a \$295 million annual Federal contribution to the Plans for 40 consecutive years, at a time when Congress is working to balance the Federal budget. Moreover, given political changes likely to occur over 40 years, it is uncertain whether Congress would continue to appropriate the necessary payments in later years even if it did so now. If Congress fails to appropriate future Federal contributions, nothing will have been accomplished. Thus, a sound solution to the unfunded pension liability problem should be immediate and conclusive, and not rely on Congress maintaining the political will to provide 40 years' worth of additional annual appropriations to the District, which is already politically weak due to its lack of voting representation in Congress.

Even if Congress fully funded annual Federal contributions of \$295 million for 40 years, the negative impact the unfunded liability has on the District -- most significantly on its bond rating

-- would continue until almost 2036.<sup>31</sup> True, H.R. 3389 would transfer some of the unfunded liability from the District's books to those of the Federal government. However, a substantial (albeit diminishing) portion of the liability would remain with the District throughout the next 40 years, most likely keeping the most attractive borrowing sources out of the District's reach.

Finally, H.R. 3389 would require the District to continue paying more than the normal costs for participants' pensions even though the District is running a severe budget deficit. While Delegate Norton's bill takes the important step of decreasing the District's payments to \$185 million per year, even that payment exceeds the District's 1995 normal costs by \$49 million. Simply put, the District cannot afford to make payments that exceed the normal costs of the Plans, nor should it be required to do so. Given the Federal responsibility for creating the unfunded liability and the District's current financial condition, H.R. 3389's reduction in the District's contributions, while significant, does not go far enough.

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<sup>31</sup> Other proposals that rely on increases in the Federal contribution over time present the same uncertainties as H.R. 3389. For example, the 1994 GAO Report, which recognized the severity of the problem, also suggested that Federal contributions should be increased to a fixed yearly amount through 2035 in order to eliminate the Plans' unfunded liability over 40 years. 1994 GAO Report at 30.

### **III. D.C. APPLESEED'S PROPOSAL**

With this Report, D.C. Appleseed proposes a logical, immediate, and enduring solution. Most importantly, this proposal is as fair as possible to all parties and assures that Plan participants will receive their promised pensions because the Plans will revert to the Federal government. Our proposal is described below in three parts, the first relating to the transfer of the current assets and liabilities of the Plans back to the Federal government, the second discussing the costs and benefits of our proposal, and the third addressing the scope of retirement benefits for District employees hired after the transfer.

#### **A. Transfer Plan Assets and Participants to the Federal Government**

The central feature of D.C. Appleseed's proposal is the transfer of the entire \$3.6 billion in net assets currently in the Plans' Retirement Fund as well as the Plan participants and liability from the District to the Federal government. The participants would remain in their three current Plans, but the Federal government would assume from the District legal responsibility for making pension payments. The District would continue to pay the normal cost of the Plans and would forward its contribution to the Federal government.

##### **1. Transfer Assets Currently in Plans' Retirement Fund to the Federal Government**

D.C. Appleseed recommends that the entire \$3.6 billion of the Plans' assets be transferred to the control of the Federal government primarily because this asset transfer makes feasible the Federal government's acceptance of the unfunded pension liability. Such a transfer could take various forms. For example, rather than a lump sum transfer, the \$3.6 billion could be placed in a trust fund which would generate income that would be permanently earmarked for funding the Plans' pay-as-you-go costs. Regardless of the form of the transfer, however, the District should

willingly part with the Retirement Fund assets if such a transfer enables the Federal government to accept the unfunded liability and, thereby, resolves the District's pension crisis.

D.C. Appleseed recognizes that there is a strong equitable argument for the District's keeping a major portion of the \$3.6 billion. Specifically, the District has paid far more than the Plans' normal costs into the Retirement Fund for each of the past 16 years.<sup>32</sup> Nonetheless, for several reasons, we recommend that the entire Retirement Fund be transferred to the Federal government.

First, in our view, the single greatest need regarding the District's pension system is to remove the Plans' unfunded liability from the District's books and to reduce the District's pension contributions to the level of "normal costs." In comparison, everything else pales, including the desirability of the District retaining some portion of the \$3.6 billion. Thus, if the transfer of the Retirement Fund assets to the Federal government enables resolution of the pension crisis, such a transfer should be welcomed by all parties.

Second, any other alternative would immediately produce protracted debate as the parties haggle over what share of the \$3.6 billion in assets belonged to whom and why. Undoubtedly there would be attempts to assess blame either on the Federal government or the District.<sup>33</sup> Such debate would certainly delay, and potentially derail, needed resolution of the unfunded liability crisis.

## **2. Return Plan Participants and Liability to the Federal Government**

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<sup>32</sup> See Exhibit 3.

<sup>33</sup> As shown above, because of the District's large contributions to the Plans above normal costs over the past 16 years, the District's continuation of the Plans' defined benefits has not caused the Plans' unfunded liability to increase.



D.C. Appleaseed recommends that at the time the \$3.6 billion in pension assets are transferred, the Federal government accept responsibility for the Plan participants and liability. Ultimately, this is a matter of necessity since only the Federal government can provide the resources to solve this problem. If the District were to default, it seems unthinkable that the Federal government would allow these pensioners to bear the brunt of mistakes that plainly are not theirs. Because the District cannot possibly fund these Plans fully, the only real question seems to be when, not whether, the Federal government will step forward and commit financially to a reasonable and permanent solution.

The only reason the Federal government has been able to continue underfunding its own pensions for so long is that, unlike any other entity, the Federal government can guarantee payment out of the general revenues of the United States Treasury. Compared to the Federal budget of over \$1.5 trillion, the District has a limited annual budget, currently about \$5 billion, from which it could never pay off such a disproportionately huge pension liability. Thus, while the Plan's \$4.7 billion unfunded pension liability is overwhelming for the District, it is a tiny part of the Federal budget.<sup>34</sup>

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<sup>34</sup> The \$4.7 billion in unfunded liabilities D.C. Appleaseed proposes transferring back to the Federal government represents less than 0.4 percent of the \$1.2 trillion unfunded pension liabilities held by the Federal government. Many of the pre-1987 Federal pension plans are underfunded as are the District Plans and their substantial unfunded liabilities are similarly increasing. Thus, many Federal pension plans had no money set aside for them, and all pensioners were paid out of annual appropriations. The following chart summarizes the current status of Federal plans.\*

<u>Federal Retirement Plan</u>	Number of Participants	Unfunded Liabilities <u>(thousands)</u> <u>(\$ in billions)</u>
Civil Service Retirement System		3,808

		\$538.3
Military Retirement System		4,498
		514.0
Federal Employee Retirement System ("FERS")		1,424
		1.8 **
32 Other Defined Benefit Plans		<u>270</u>
		<u>165.9</u>
	10,000	
		\$1,220.
		0
	=====	=====

\* Data taken from "Public Pensions: Summary of Federal Pension Plan Data," U.S. General Accounting Office (Feb. 1996) (GAO/AIMD-96-6) (hereinafter "1996 GAO Report").

\*\* These unfunded liabilities are so low because FERS is primarily a defined contribution plan that in October 1987, for all workers hired after that date, replaced the Civil Service Retirement System, a defined benefit plan.

Apart from necessity, there are several other substantial reasons that the Federal government should assume this liability. First, the pension problem began when the participants were under Federal control and paid by the Federal government. At that time, contributions withheld from the participants and contributions paid by the District agencies that employed the participants were deposited into the Federal Treasury and treated as Federal revenue in the year of receipt. Thus, the Federal government not only failed to pay its share, but also used participants' withholdings (and District contributions) as general revenue.

When the issue first came before the Federal government in 1978, President Carter vetoed the bill that would have reduced, but not eliminated, the unfunded liability. His primary justification -- that abuses in disability benefits occurring prior to Home Rule were attributable to the District government but not the Federal government -- was, and still is, unfounded. Prior to the commencement of Home Rule on January 2, 1975, the Federal government alone set standards for disability benefits and administered the Plans. Any inadequate management of the Plans prior to Home Rule must, therefore, be attributed solely to the Federal government.

Thus, all of the current \$4.7 billion unfunded liability results from the unfunded liabilities created prior to Home Rule and then transferred by the Federal government to the District.<sup>35</sup> Nonetheless, the Federal government has done little to cure this obvious problem.

Second, proposals to increase the Federal contributions over a long period of time (1) are too uncertain given the vagaries of congressional politics and (2) will not eliminate the negative effects of the unfunded liability on the District's fiscal health and borrowing capability for many

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<sup>35</sup> See Exhibit 4, "Summary of Retirement Plans' Underfunding by Year: 1980-95." See also note 14 above.

years. By contrast, the immediate return of the Plans' liabilities to the Federal government will require Congress to act only once, and will immediately eliminate the unfunded liability and its negative effects on the District.

Finally, the District would not be coming to the Federal government empty handed, but would be transferring \$3.6 billion to the Federal government. Almost half of this money was contributed by the District in excess of pension liabilities created between 1979 and 1996 when the District was responsible for the Plans. In other words, the District would be making a \$1.75 billion contribution to the Federal government, which could be used to offset the cost of the unfunded liability to the Federal government. Rarely, if ever, does Congress get an offer by a city or state to contribute money to the Federal government, let alone an offer of over a billion dollars.

**B. The Costs and Benefits of D.C. Appleseed's Proposal**

**1. Benefits to Participants**

Current participants of the Plans transferred back to the Federal government will enjoy substantial benefits if D.C. Appleseed's proposal is adopted. All pension plans are only as good as their financial backing. Even with their \$3.6 billion in assets, the District Plans are insolvent and, therefore, funding for participants' retirement benefits will eventually need to be derived from some other source. It is plainly better for the Plan participants to receive a guarantee of payment from the Federal Treasury than from the District.

Police officers, firefighters, teachers, and judges hired after the transfer of unfunded liabilities to the Federal government would also benefit. As discussed below, those new hires would be placed in plans for which the District would retain full responsibility. By eliminating current unfunded liabilities, D.C. Appleseed's proposal will give new hires assurance that contributions made to their pension plans will not be used to cover past unfunded liabilities.

These employees will receive the guarantee of payment from a soundly funded pension plan.<sup>36</sup>

## 2. **Benefits to the District**

The primary benefit to the District will be relief from the unfunded liability and its high annual pension costs. The District will no longer have to make a \$298 million plus annual payment, but instead will pay only the normal costs of the participants' pensions -- currently about \$136 million per year. This reduction in pension costs would balance the District of Columbia's budget, even in years such as 1995 when the District incurred a \$54 million deficit. Reduced contributions would also elevate the District's bonds out of the "junk bond" category, thereby lowering interest costs and reducing the potential need for additional revenue.

In addition, the District would save much of the \$10 million now spent annually to operate the District of Columbia Retirement Board, including the amount paid to investment advisors. The Retirement Board's current duties of investing the \$3.6 billion in Retirement Fund assets would be assumed by the Federal government, which would not incur a commensurate increase in expenditures because it does not invest its pension assets beyond special nonmarketable Treasury securities.<sup>37</sup> The District would only need to fund a scaled down version of the Retirement Board to invest or manage the assets placed in pension plans of new hires.

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<sup>36</sup> This assumes, of course, that the District will not recreate significant future unfunded pension liability.

<sup>37</sup> See 1996 GAO Report at 218-19. Of the \$471.2 billion invested in 34 Federal defined benefit pension plans, \$461.2 billion are in U.S. government obligations and \$10 billion are in other investments.

### **3. Costs and Benefits to the Federal Government**

Although in the long-run, transfer of participants to the Federal government plans will cost the Federal government money, it is important to note that there are clear benefits to the Federal budget that would accrue from this transfer. First and foremost, the Federal government will receive \$3.6 billion from the Retirement Fund's current assets, which could be used to offset the costs of reassuming responsibility for the Plans. The Federal government will also eliminate its current \$52 million annual pension payment to the Plans and receive an additional payment (currently \$136 million) from the District annually to cover the Plans' normal costs, which would also offset some of the liability assumed by the Federal government.

Second, because the Federal government has substantial responsibility for the District, all of the financial benefits to the District outlined above also benefit the Federal government. By solving the pension crisis, and thereby increasing the District's short-term cash flow and long-term financial security, the Federal government would reduce the likelihood that the District (as opposed to the Plans) will need to be "bailed out" financially in the future.

The Federal government, which stands to pay the most, may not welcome an unfunded net liability of \$4.7 billion. But, regardless of whether the Federal government is responsible for some or all of the current unfunded liability, the Federal government is the only place that the District and the Plans' participants can turn. The District cannot pay the Plans' benefits without a cash infusion from some other source. The Federal government must act unless it is prepared to leave thousands of public employees in the Nation's Capital with virtually no retirement because they were hired and placed in unsound pension Plans that grew increasingly unsound each year, through no fault of their own. Given the difficult choices, the solution outlined above is the only immediate, lasting, and reliable option for ending this dilemma.

### **C. Establishing Pension Plans for New Hires**

If the current Plans are returned to the Federal government as recommended above -- which means that all pension assets and liabilities will be transferred to the Federal government -- the District will have to establish new pension plans for those police officers, firefighters, teachers, and judges hired subsequent to the transfer. These new plans would not only have a fresh start, with no unfunded liabilities, but would also require no Federal contributions and create no Federal liability. In other words, the District government would retain complete control over the administration of, and liability for, such plans. Accordingly, the District, subject to review by Congress through the budgetary process, should design future benefit plans that will eliminate the risk of any further pension funding crises.

Since such risks arise primarily, if not exclusively, in connection with defined benefit pension arrangements, such as the existing Plans, the District should determine whether defined contribution plans can do an equally effective job of providing adequate and competitive pensions to District employees, without exposing the District to the perils of unforeseen funding liabilities. This Report does not endorse either type of plan but, instead, discusses some of the advantages and disadvantages that could result from each approach.

First, replacing defined benefit with defined contribution coverage should be attractive to younger District employees. In defined contribution plans, the pension benefit provided to the employee is based entirely on the amount of money contributed by employees and the employer, plus net investment earnings on those contributions. Employees become entitled to greater benefits in defined contribution plans significantly earlier than in traditional defined benefit plans, which usually grant benefits that have little economic value to younger participants.

A related advantage is that defined contribution plan benefits are usually more portable

than benefits under traditional defined benefit plans. Participants in defined contribution plans generally can obtain lump sum cashouts of their benefits much more readily than can participants in traditional defined benefit plans.<sup>38</sup> This is an important advantage for those who spend only part of their careers working for the District government and later move to jobs with other employers. In addition, defined contribution plans generally offer employees greater control over investments.

Creating defined contribution rather than defined benefit plans would also eliminate the risk that the District will be liable for anything beyond its stated contributions. Similarly, the creation of defined contribution plans would eliminate the risk that the Federal government would have to help out the District if, for instance, the District was unable to contribute enough to cover the normal cost of the pensions.<sup>39</sup> Finally, establishing defined contribution plans would allow the District to significantly scale back the current Retirement Board and save the greater administrative expenses, investment advisor fees, and actuarial expenses associated with defined benefit plans.

There is precedent for creating defined contribution plans for new District employees where previous employees received defined benefit coverage. Beginning in fiscal year 1988, the District placed all new hires except police officers, firefighters, teachers, and judges into a District-administered defined contribution plan.<sup>40</sup> Such a change has been contemplated for

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<sup>38</sup> Although it is possible to provide lump sum cashouts in defined benefit plans, it has not been traditional to do so, except in limited circumstances.

<sup>39</sup> As noted above, the District's contributions since 1979, which were set by Congress, have more than covered the normal costs of the pension plans.

<sup>40</sup> This mirrored the Federal government's establishment of FERS for most Federal civilian



remaining new hires as well; Chairman David Clarke introduced a bill into the District of Columbia Council in 1995 that would have placed police officers, firefighters, teachers, and judges hired after September 30, 1995 into defined contribution plans.<sup>41</sup>

Nonetheless, several problems associated with any potential switch of District police officers, firefighters, teachers, and judges to defined contribution coverage deserve attention. First, defined contribution plans may sometimes provide insufficient benefits in the event of death or service disability, especially with respect to younger police and fire personnel. Thus, a defined contribution plan approach may require supplementation through life and disability insurance.

Second, defined contribution plans provide less protection than defined benefit plans to employees who retire or terminate during a period when investment returns are showing sharp downward trends. Of course, the converse is also true -- defined contribution plans are particularly profitable to those who retire when investment returns are on a sustained upswing. Nonetheless, the downside of this risk may be distressing to some employees.<sup>42</sup>

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employees.

<sup>41</sup> While the "Police Officers', Fire Fighters' and Teachers' Retirement Reform Amendment Act of 1995," D.C. Bill 11-316 (June 8, 1995), was still pending before the District Council on the date of this Report's publication, Chairman Clarke has apparently abandoned this effort and is now working with Mayor Barry's office to draft replacement legislation that would create new defined benefit, rather than defined contribution, plans for police officers, firefighters, and teachers.

<sup>42</sup> One way to alleviate this problem would be to adopt an approach that combines defined contribution and defined benefit features, such as a "cash balance" plan for District employees. A "cash balance plan" is a defined benefit plan where the benefit is defined as an individual account within the plan. The plan specifies the rates of contribution and investment return (independent of plan asset performance) to be credited to the employee's account. If plan asset performance exceeds the specified investment return, the excess would belong to the plans and would be used to reduce future contribution obligations. The plan looks to the employee like a defined contribution plan for benefit accrual purposes, and the employee avoids the downside risk of poor investment performance. The disadvantage to such a plan is that, as with any defined benefit plan,

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the employer (here, the District) alone incurs the risk of shortfalls. It should be noted that many of the characteristics attributed in the above text to traditional defined benefit plans do not apply to cash balance plans, which generally mimic defined contribution plans quite closely.

Third, there are very few defined contribution plans for police and fire personnel in state and local jurisdictions, including those bordering the District. Thus, if the District establishes a defined contribution plan for newly hired police and fire personnel that is perceived as less valuable than defined benefit plans in surrounding jurisdictions, the creation of such plans could place the District at a competitive disadvantage in terms of attracting high quality police and fire personnel.<sup>43</sup>

When establishing new plans, the District need not create a single set of retirement benefits for police officers, firefighters, teachers, and judges. For example, the District could place employees whose jobs entail high risk of personal injury -- police officers and firefighters -- in defined benefit plans, and lower risk employees -- judges and teachers -- in defined contribution plans. This determination requires further study by the District, including consideration of relevant factors such as relative costs of the plans and whether the District would be placed at a competitive disadvantage by establishing a particular type of plan for a specific group of employees.

The District would not create the fiscal burden that has resulted from the current unfunded liabilities simply by continuing defined benefit coverage for any or all of the categories of employees discussed above. Thus, unlike the unfunded liability issue – on which there is universal recognition that the District cannot survive without significant Federal intervention – choosing a defined benefit plan, a defined contribution plan, or some hybrid, requires a standard

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<sup>43</sup> Although defined benefit plans are the prevalent pension systems for state and municipal police and fire employees, many Federal employees hired since 1987 who perform functions similar to District police and fire personnel are covered under FERS, which is primarily a defined contribution plan.

cost-benefit analysis.

Accordingly, D.C. Appleseed does not recommend the adoption of any particular type of plan, or any special treatment for future hires. We simply urge that careful consideration be given to the future role of pension plans for the District's police officers, firefighters, teachers, and judges, and that such plans be designed to ensure that no significant unfunded liability is created in the future.

### **CONCLUSION**

Whatever other financial and operational difficulties the District faces, the unfunded pension liability is an independent problem presenting profoundly destructive repercussions for the District. Given the seriousness of the harm and the fact that it worsens every day, something must be done to solve this problem without further delay. The most equitable and reliable solution is for the Plans' assets and liabilities to be transferred to the Federal government.

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- Employee Retirement Income and Security Act, Pub. L. No. 93-406 (1974), 29 U.S.C. secs. 1001-1461 (1995).