Two-fifths of state and local government employees will be eligible to retire between 2000 and 2015. Phased retirement is one strategy governments are using to retain skilled older workers and minimize training costs.

Please Don't Go! Why Phased Retirement May Make Sense for Your Government

By Brian Flahaven

Encouraging governments to consider employee retention programs may seem a bit odd, especially when many are currently dealing with revenue shortfalls and tight budgets. When times are tough, governments often look for ways to remove highly paid older workers from the payroll using a variety of early retirement incentives. For the past 20 years, early retirement programs have been popular public sector money saving strategies. This year alone, a number of state and local governments enacted early retirement programs in an attempt to reduce budget deficits and avoid layoffs.

But while early retirement programs can help governments avert short-term budget problems, these programs may damage a government's ability to function in the long term. Over the next two decades, 76 million baby boomers are going to reach retirement age; many of these baby boomers currently work in the public sector as managers, finance officers, teachers, and technicians. Governments already are struggling to find well-trained and experienced finance officers, even in the current economic environment. With a decreasing number of graduates projected to enter the workforce each year, public sector managers need to ask themselves if it is truly in their governments' best interest to encourage early retirement among older employees.

Many governments are trying to retain skilled older workers through phased retirement programs. Phased retirement is very popular among older employees, many of whom want or need to keep earning income after retirement age. Though the type of program can vary from government to government, all phased retirement plans offer incentives to keep older employees on the payroll. Although the benefits of phased retirement for employers and employees are numerous, there remain a number of administrative and legal barriers that threaten to halt its progress as a widespread strategy for blunting the effects of future labor shortages. Governments will need to consider the long-term implications of the baby boomer retirement wave, and examine whether phased retirement is the right strategy for them.

What Is Phased Retirement?

Perhaps because it varies from jurisdiction to jurisdiction, phased retirement lacks a formal definition. The U.S. Department of Labor's Working Group on Phased Retirement defines it as "a gradual change in a person's work arrangements as a transition toward full retirement."[1] Under this broad definition, work completed for the same employer or a different employer before full retirement, whether it is part time or full time, is considered phased retirement.

Most scholars and practitioners, however, limit the concept to continued work past normal retirement for the same employer or employers within the same system. Phased retirement programs are usually "sold" as a way for employers to keep valued employees past their pension plan's early or normal retirement age. Programs like retiree pools, job sharing arrangements, part-time work, part-year work, and telecommuting are all attempts to retain older employees by reducing job responsibilities and/or hours worked.

The deferred retirement option plan, or DROP, is the most common public sector phased retirement plan. Interestingly, some early DROPs were designed to enhance the retirement benefits of police and fire personnel whose careers tend to be relatively short; they were not explicitly conceived as phased retirement programs.[2] Now, governments are using DROPs as a way to retain experienced staff for additional years. Instead of retiring and receiving benefits from their defined benefit pension plans, DROP participants continue to work full time for a period of usually three to five years. Since DROP participants are considered retired employees, their monthly pension benefits (frozen at the time of program entry) are deposited in a separate account. Depending on the DROP plan, either the program participants or the employer determines how the deposited pension benefits will earn a return. When the DROP period ends, the accumulated pension benefits are paid to the participant. The decision to enter a DROP plan is usually irrevocable, and employees that exit the plan early can be subject to large penalties.[3]

Another type of phased retirement program involves rehiring employees after they formally retire. Unlike DROPs, these "retire-rehire" plans allow employees to continue working for the same employer on a reduced schedule for an unlimited amount of time. Most plans require employees to separate from service for a specified amount of time. In July 2001, the State of Washington enacted a retire-rehire plan in response to a critical teacher shortage. Washington requires retired employees to separate from service for at least 30 days. If former employees are rehired by the state, they are limited to a certain number of hours per year depending on their retirement plan. Employment agreements are in effect for only one-year periods.

Demographics and Other Variables Driving Phased Retirement

Two years ago, the labor shortage was the driving force behind the movement for phased retirement. Employers, facing a tight labor market, saw phased retirement as a way to win the "war for talent." Now, with revenues sliding and the economy struggling, public and private sector employers are trying to reduce the number of employees through layoffs or early retirement incentives. So why is phased retirement, aimed at worker retention, still on the agenda in the current economic environment?

Despite the cyclical downturn, there are a number of isolated labor shortages in certain industries. As is the case in the State of Washington, many states are facing teacher shortages. The U.S. Bureau of Labor Statistics projects that between 1998 and 2008, more than 400,000 elementary school teachers and more than 350,000 secondary school teachers will be needed to replace retiring teachers.[4] In particular, school districts are struggling to find talented and qualified special education teachers. States are using phased retirement programs in an effort to stem these shortages. Police and fire personnel, nurses, and information technology professionals are also in comparatively high demand.

Many older workers want to continue working past normal retirement age. According to the 2002 Retirement Confidence Survey sponsored by the Employee Benefit Research Institute, 67 percent of working respondents believe they will work for pay after retirement. Of these respondents, 65 percent want to continue working after retirement because they enjoy working and want to stay involved.[5] Some older workers are reluctant to give up the sense of personal fulfillment provided by their career job.

For others, working past retirement age is a necessity. The Retirement Confidence Survey also found that 33 percent of the respondents will work past retirement because they will need the extra income to make ends meet. The recent downturn in the economy and losses on Wall Street, coupled with the rising cost of health care, also may keep older employees in the workforce for a longer period of time. In general, workers who want to maintain their standard of living in retirement need 75 to 85 percent of their pre-retirement income. As health care costs continue to escalate, retirees may need closer to 100 percent of pre-retirement income to maintain their standard of living.[6] Phased retirement has become an attractive idea to those who want and need to continue working past retirement.

Although isolated labor shortages and worker preferences are the most significant motivations for phased retirement programs, the impending retirement of millions of baby boomers in the next two decades promises to drive the issue in the long run. Anna Rappaport, a principal with the human resources consulting firm Mercer, believes that the economic downturn is merely deferring the long-term workforce issues that will re-emerge over time. "Employers are in a downsizing mode right now. The potential loss of talented and experienced employees to retirement is taking a back seat to shedding employees."

The baby boom retirement will hit the public sector especially hard, since governments tend to have an older workforce than private sector firms.[7] In his study of the public sector, Samuel Ehrenhalt found that two-fifths of state and local government employees will be eligible to retire between 2000 and 2015. The federal government, according to Ehrenhalt, will see 30 percent of its 1.6 million workforce become eligible for retirement between 2000 and 2005.[8] Early retirement could accelerate this loss of seasoned public employees. Most public employee pension plans have a normal retirement age of 60 or 62, three to five years below Social Security's normal retirement age of 65.[9] The most common early retirement age in public pension plans is 55.[10] It is reasonable to assume that the early retirement trend will continue in the public sector as long as employers maintain the normal and early retirement ages at their current levels.

Benefits of Phased Retirement

Well-designed phased retirement programs can help both employers and employees deal with the changing composition of the workforce. Employers can address the labor shortage issues while employees can continue to earn the income they need to live comfortably in their retirement years. There are several other benefits of phased retirement for both employers and employees.

Retention of human capital is an extremely attractive feature of phased retirement for employers. "[Phased retirement] programs provide a way of retaining institutional knowledge and specialized skill, boosting productivity by keeping highly experienced workers rather than hiring lower-skilled ones," says Mercer's Rappaport.[11] Older workers may know how to navigate an organization's bureaucracy and may have skills that are not easily transferable to younger workers. Additionally, older workers tend to be very loyal, a function of long tenures with one employer.

If designed properly, phased retirement programs can reduce employers' training and hiring costs. It may be cheaper to retain an older employee with specialized expertise than to try to find and then train another person to do the same job. Hiring costs are likely to increase as the pool of skilled young workers continues to shrink. Employers are often afraid that their valued older employees will retire and then go to work for a competitor. Indeed, the increasing number of "bridge" jobs, whereby retirees work part time for a different employer, suggests that this may continue to happen in the absence of phased retirement.

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Employees also benefit from phased retirement. Many older employees want to continue to work after normal retirement age either out of necessity or pleasure. Phased retirement offers this kind of flexibility. Employees who wish to continue working but who also want to enjoy the advantages of retired life will find phased retirement on a part-time schedule very attractive. Kathy Harm, director of relationship development for the ICMA Retirement Corporation, claims that phased retirement gives older employees a chance to "try out" full retirement. "It allows employees to consider whether they really want to completely give up a meaningful part of their life," she said.[12]

Society in general could benefit from the widespread use of phased retirement programs. The longer employees stay in the workforce, the longer they pay taxes and contribute to Social Security, Medicare, and other government entitlement programs. Phased retirees could mitigate the fiscal pressure on these programs.

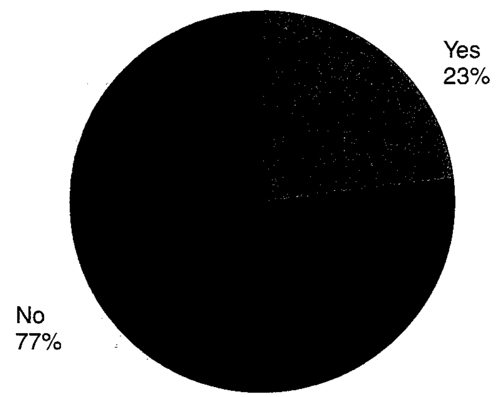
Barriers to Phased Retirement

Despite their attractive features, formal phased retirement programs are not pervasive in either the private sector or the public sector. In a recent Mercer survey, a clear majority of public and private sector employers did not offer formal phased retirement programs (Exhibit 1).[13] The legal and financial obstacles to program implementation partially explain this lack of interest.

Pension plan designs tend to encourage early retirement. Many plans allow workers to retire in their late fifties or early sixties, well

Exhibit 1

EMPLOYERS OFFERING PHASED RETIREMENT



Source: Mercer, Inc., 2001.

before Social Security's normal retirement age. Work after the plan's normal retirement age often is penalized. A recent survey of 1,000 firms by the Committee for Economic Development found that continued work after early retirement eligibility typically reduced the lifetime value of a pension by the equivalent of a 30 percent pay cut.[14] All other things being equal, older workers are not going to participate in phased retirement programs if participation results in lower pension benefits. Defined benefit pension plans also tend to base retirement benefits on an employee's average salary during the last three to five years of full-time work. This final average pay formula can hurt phased retirees, who often work part time and earn less income during their final work years.

Federal regulations governing "in-service distributions" of defined benefit pension plans also serve as stumbling blocks. The Employee Retirement Income Security Act of 1974, commonly known by the acronym ERISA, prohibits in-service distributions, or the distribution of pension benefits prior to the plan's normal retirement age. Phased retirees often need their pension benefits as a supplemental source of income during their years of part-time employment. ERISA practically forces older workers to retire fully from their career before seeking employment elsewhere.[15] To move ahead with phased retirement, a majority of states would need to allow in-service distributions as part of their public pension plans. Though defined contribution plans are not subject to the in-service distribution restriction, any pension benefit payments made to an employee prior to age 59 is subject to a 10 percent tax.

Over the past few years, proponents of phased retirement have tried to reduce these legal barriers. In 2000, federal legislation was introduced that would have allowed pension payments during employment after an employee reached either normal retirement age (59½) or 30 years of service. Although it failed to reach the floor of both chambers of Congress, the legislation will likely be revisited in the future.[16] Earlier this year, the Internal Revenue Service began taking public comments on the issue of in-service benefit distributions.[17] Existing federal regulations, however, still remain in force and congressional action on the issue this year is doubtful.

Perhaps the greatest barrier to implementation is health care. While older workers are as healthy as they have ever been, they still tend to have more work-limiting health problems than younger workers.[18] Employers worry that retaining a large number of older workers will increase the cost of their employee health plans. Additionally, employers do not usually offer health care benefits to part-time employees. Plans that offer good health care benefits for full-time workers and retirees, but none for part-time workers, encourage older workers to retire or stay employed while discouraging part-time phased retirement. Finding a way to retain older employees without increasing health care costs will prove to be a challenge for employers.

On top of plan design, federal regulations, and health care costs, negative perceptions of older workers are also obstacles to phased retirement. In a recent survey by the American Association of Retired Persons, employers indicated that older workers ranked below average in their ability to deal with new technology and learn new skills.[19] Although studies show that these negative perceptions are often unfounded, many employers still retain these stereotypes and will need to adopt a new attitude toward older workers if phased retirement is to succeed.

Although these obstacles can be formidable to any employer interested in developing a phased retirement program, the public sector may be able to overcome them before the private sector. Governments are not subject to ERISA and its prohibition of in-service benefit distributions. State statutes usually govern public sector plans. For instance, DROPs, which allocate pension payments into an account while the employee is still working, are perfectly legal in the public sector if approved by the appropriate governing body. A number of phased retirement plans in the public sector, including the State of Washington's retire-rehire program, allow participants to maintain full health care coverage. Also, the public sector is currently facing selective labor shortages in occupations such as teaching and public safety. Recent survey results suggest that formal phased retirement programs are more common in the public sector than the private sector (Exhibit 2).

Does Phased Retirement Make Sense for Your Jurisdiction?

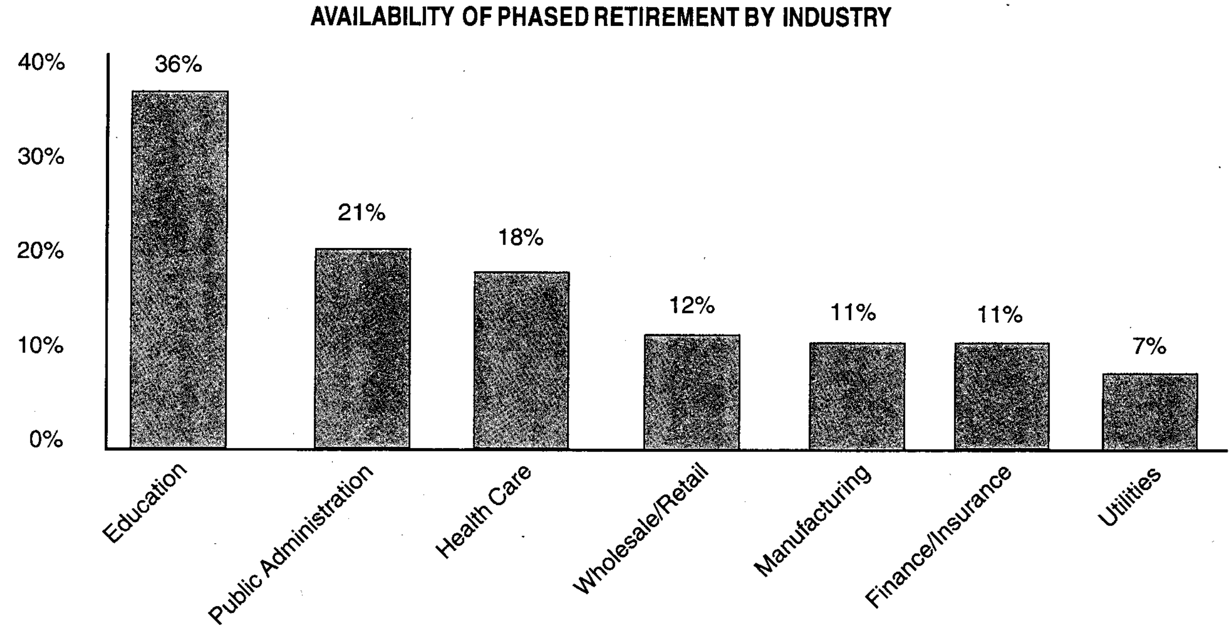
The biggest obstacle to phased retirement is employer priorities. Asked why they do not have phased retirement programs, a majority of the respondents to the Mercer survey answered that phased retirement was simply not a priority.[20] Many employers and governments are not facing an immediate labor shortage. Instead, they are trying to get rid of employees as they wrestle with budget shortfalls and reduced profits.

Employers and governments should take time to analyze their current workforce, paying particular attention to occupations requiring specialized expertise, such as public finance. It is also important that employers look at the labor market in their jurisdiction. Are there enough young, skilled workers available to replace workers scheduled to retire? More importantly, can the employer maintain quality service and productivity with these new workers? A talent risk assessment can be an extremely helpful tool for employers examining their current workforce situation.

Employers need to be aware of the potential consequences of phased retirement programs. For example, will the program under consideration retain the employees that the employer wants to retain? Obviously, employers do not want to establish a program that will keep poor performing, over-paid employees in the workforce indefinitely. Defining hours limits for phased retirees can help employers shed unproductive phased retirees. But employers need to be careful to avoid programs that will result in a large number of phased retirees leaving the workforce all at once.

Health care issues also need to be considered by employers. If their health care plan offers attractive retirement coverage and unattractive part-time coverage, they may want to consider reworking or adding benefits. Older workers are unlikely to participate in a phased retirement program that eliminates or significantly reduces their health care coverage.

Exhibit 2



Source: Watson Wyatt Worldwide, 1999.

Public sector employers also may need to reconsider early retirement incentives. Although early retirement programs may reduce budgetary pressures in the short term, they are often blunt instruments. An unintended consequence may be that the employees who choose to take the incentive may include specialized, skilled, and talented employees, whereas lower performing employees may decide to remain on the payroll.

Phased retirement has tremendous potential. It helps employers retain their experienced and skilled staff. It allows employees to continue to work past normal retirement age. It is one way to address the impending retirement of the baby boom generation. However, a number of obstacles to its implementation remain, including employer priorities. Governments need to examine how their workforce will look in the long run. In doing so, they may find that a phased retirement plan can help them maintain the top-notch staff and quality service that citizens depend on.

NOTES

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