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# Privatizing Government Pensions:

## *The United States and the Netherlands*

**by Philip de Jong and John A. Turner**

► **The Thrift Savings Plan for U.S. federal government workers and the Account Balance Pension for Dutch government employees are two of the largest pension funds in the world.** *These plans provide evidence on the successful government management of funded pensions, on ways pensions can be privatized for government employees, and on models for privatizing social security.*◄

While most workers around the world are not covered by either an occupational pension plan or social security, government employees are covered by an occupational pension plan in nearly all countries. These plans are generally financed on a pay-as-you-go basis. Many of these plans were started before the national social security system, and for that reason government employees often were excluded from social security when it was instituted. Government employees in France, Greece, Italy and Spain are still excluded from the national social security plan. In a total of 75 out of 158 countries with social security systems, government employees are excluded (Rajnes 1998). This practice is less prevalent in the Organization for Economic Cooperation and Development (OECD) countries than in the rest of the world, however, as government employees are included in Australia, Canada, Switzerland, the United Kingdom and the Netherlands.

In 1983, the United States reformed the retirement program covering most federal government employees. The Civil Service Retirement System (CSRS) was closed to new members, and all new employees of the federal government were required to participate in Social Security and join the new system, called the Federal Employees Retirement System (FERS). This reform succeeded in partially privatizing the provision of retirement income to federal government employees through private sector investments managed by the private sector.

In contrast to most plans for government workers, including a significant part of the U.S. system, the plan in the Netherlands is fully funded with investments in domestic and world capital markets. In 1996, a reform privatized this system. After a transition period, ending on January 1, 2001, sectors of employees can leave the government-provided plan and have their pension provided by a private sector insurance company.

The Thrift Savings Plan (TSP) for U.S. government employees and the older and larger Account Balance Pension (ABP) plan for Dutch government employees are two of the largest pension funds in the world. The ABP plan is the largest fund in Europe. The Thrift Savings Plan is projected to be the largest pension fund in North America. These plans are of interest because of

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their size but, more significantly, they provide evidence on the government management of funded pensions, on ways that pensions can be privatized for government employees and on models for privatizing social security. The Netherlands has gone further than the United States in privatizing government pensions.

## U.S. FEDERAL EMPLOYEE RETIREMENT SYSTEM (FERS)

The Social Security Amendments of 1983 brought all general service federal civilian employees hired after December 1983 into the Social Security system. This change was primarily intended to improve the short-run financing of Social Security by bringing more contributors into the system.

While the federal government retirement system covers most categories of federal workers, it does not include government employees in state and local government; nor does it include the armed forces. In addition, several small systems cover specialized groups—diplomats (State Department), spies (Central Intelligence Agency) and central bankers (Federal Reserve Board).

Members of the old system were given the option of switching to the new system, but only 2.8% did. It was generally thought that the new system was better for workers who intended to leave the government before retirement, but that the old system was better for workers who intended to stay until retirement. The old system offers several advantages to workers who plan on staying with the government until retirement. It offers better protection against inflation after retirement, full retirement benefits at a lower retirement age and less risk, since it is entirely a defined benefit plan, while the new system relies in part on a defined contribution plan. Workers who plan on leaving the government before retirement age, however, are penalized because their retirement benefit is based on their final salary that is not adjusted for inflation between the point of departure and the age of receipt of benefits. The new system is better for workers who plan on leaving the government because it is more portable. Its portability features include coverage under Social Security and coverage through a defined contribution plan, both of which provide fully portable benefits.

Because few workers switched from the old system to the new one, these two systems coexist and are by far the largest retirement systems for federal government employees. Each now covers nearly half of the 2.8 million active federal civilian employees not covered under other federal retirement systems.

Inclusion of federal government employees in Social Security necessitated restructuring their retirement income benefits. FERS was designed so that it would provide retirement income comparable to that provided by large private sector employers. In the private sector, most large enterprises offer their employees a defined benefit plan and a supplementary defined contribution plan in addition to Social Security. FERS adopted this approach. It provides federal workers coverage under Social Security, a defined benefit plan and the TSP, which is a defined contribution plan.

FERS employees pay full Social Security contributions. In addition, they contribute 0.8% of pay to the Basic Benefit Plan, which is the defined benefit plan. The required contribution of federal government employees is an unusual feature in the United States. Few private sector employers require employees to contribute to their defined benefit plans because this contribution is not tax-deductible, while employer contributions are.

The FERS plan provides substantially reduced retiree cost-of-living adjustments (COLAs) compared to the nearly full COLAs provided by the CSRS. FERS retirees do not receive COLAs until age 62—an incentive to postpone retirement until age 62—while in the CSRS COLAs are available at retirement, which could occur seven years earlier, at age 55. The FERS COLA provides full protection up to an inflation rate of 2%. For inflation of 3% or more, its COLA equals the increase in the Consumer Price Index (CPI) less 1%.

### *Thrift Savings Plan (TSP)*

The TSP offers federal workers the same savings and tax benefits that many private corporations offer their employees under 401(k) plans. By participating in the TSP, workers can save part of their income for retirement, receive matching government contributions and reduce their current taxes. The TSP is the part of federal retirement income that the worker can control because the worker decides how much to contribute, how to invest it and, when retired, how to receive the money.

The plan is administered by an independent government agency, the Federal Retirement Thrift Investment Board, which is charged with operating the plan prudently and solely in the interest of the participants and their beneficiaries.

In the TSP, like 401(k) plans in the private sector, workers contribute beforetax earnings. For FERS employees, the federal government automatically contributes 1% of pay. Workers in FERS are not required to contribute but may contribute up to 10% of pay. For workers who choose to contribute, the federal government matches their contribution up to 5% of pay—dollar for dollar for the first 3% and 50 cents per dollar for the next 2%, for a maximum government contribution of 5% of pay, and a maximum total contribution of 15%.

While the accumulated funds in the basic FERS plan, CSRS and Social Security are all invested in Treasury securities, the TSP provides three funds in which participants can invest any portion of their contributions. The G fund holds short-term U.S. Treasury securities specially issued to the plan. The F fund is invested in a bond index fund that tracks the performance of the Lehman Brothers Aggregate Bond Index. This index consists primarily of high-quality, fixed income securities representing the U.S. government, corporate and mortgage-backed securities sectors of the U.S. bond market. The C fund is invested in a Standard & Poor's (S&P) 500 Index fund.

### *Other Provisions Under the FERS System*

The minimum retirement age under the FERS plan depends on the year the worker was born. Workers born before 1948 can retire at age 55 with 30 years of service. Workers under the civil service plan can retire at age 55 if they have 30 years of service. Workers born in 1970 and later can retire at age 57, and workers born in the intervening years have minimum retirement ages between ages 55 and 57. Workers who do not meet the requirement of 30 years of service can retire at age 60 with 20 years and age 62 with five years. In addition, workers can retire at their minimum retirement age with ten years of service at a reduced benefit.

The basic benefit is based on the worker's "high three average pay," figured by averaging the highest basic pay over any three consecutive years of service. The benefit is calculated as 1% of the high three average pay times years of service, so that a worker with 30 years of service would receive 30% of his or her high three average pay. For workers who retire at age 62 with 20 or more years of service, the benefit formula uses a more generous figure of 1.1 times years of service. In addition, workers who retire at the minimum retirement age with 30 years of service or at age 60 with 20 years receive a supplemental annuity, payable until age 62 when they begin receiving their Social Security annuity.


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FERS is considered fully funded or nearly fully funded under different actuarial measures. Federal retirement benefits in the Basic Benefit Plan, however, are not prefunded in the way that private pension plans set aside money during employees' working years to cover the accruing costs of these benefits because the plans' assets are largely invested in Treasury securities. Resources must be available—either through general tax revenues or borrowing—when the securities are redeemed to pay retirement benefits.

FERS funding uses a "normal cost" approach, or the set aside of a percentage of payroll during employees' working years that, with investment earnings, should be sufficient to cover future benefit payments. The CSRS approach, unlike that used in the FERS plan, calculates future costs without factoring in either COLAs or pay increases. Under the FERS system, agencies are required to contribute this extra amount to bridge the gap between expected costs and employee contributions.

## CONCLUSIONS FOR THE U.S. SYSTEM

The reform of the U.S. civil service pension system achieved the following seven objectives:

1. It brought newly hired civil servants into the Social Security system, which improved the financial outlook of that system and moved Social Security closer to universal coverage.
2. It resulted in a retirement system for federal government workers more comparable to that of private sector workers.
3. It raised the minimum retirement age by two years, bringing the minimum retirement age more in line with that prevailing in private sector pension plans.
4. It partially privatized federal government retirement by instituting a funded defined contribution plan with some private sector investment. This was done by providing a 401(k)-type plan to federal workers.
5. It improved portability for federal government employees, facilitating mobility into and out of the civil service.
6. It improved the funding of pensions for government workers.
7. It reduced the cost to the government of providing pensions for government workers.

## THE NETHERLANDS

The Netherlands has a limited social security system that provides flat-rate benefits, with supplementary occupational pensions needed to provide an adequate retirement income. Each individual age 65 or older, whether retired or not, is entitled to a benefit of 50% of the statutory minimum wage, with a supplement of 20% for single persons, 40% for single parents with a dependent child and up to 50% for persons with a partner younger than 65.

The Dutch public service pension fund for government employees, called the ABP fund, has nearly 900,000 active employees and a total of two million participants, including beneficiaries and former employees. It was established in the 1960s. With NLG 500 billion in assets in 1997 (approximately $250 billion), it is one of the largest pension funds in the world.

All government employees covered by this plan are also covered by the Dutch social security system. The ABP fund supplements the social security benefit.

In 1998, the contribution rate for the fund was 13.2%, of which the employer pays 9.9% and the employee pays 3.3%. The contribution rate varies annually depending on the investment experience of the plan. However, the calculation of the premium rate uses a procedure that smooths out the fluctuations in the premium rate, so the annual variation is small. Because the ABP requires workers to contribute based on investment performance, while basing benefits on a formula, it requires workers to bear some investment risk, and in that respect is similar to a defined contribution plan.

The ABP is a fully funded defined benefit plan. The ABP plan is funded using capital market investments and thus differs from the defined benefit Basic Benefit Plan for U.S. government civil servants, which is funded entirely through investments in U.S. government securities.

The ABP is an indexed final pay plan, with indexing to the wages of government employees. Collectively bargained wage agreements for workers are made for two or three years. They stipulate the annual wage growth for the period they cover. The ABP plan states that it aims to provide benefit indexing based on wage growth, but this is not a legal or contractual requirement. This is more generous indexing than in the United States, since wages tend to rise faster than prices.

The benefit formula is 1.75% times years of service times final pay. This benefit formula gives a maximum of 70% of final pay for workers who work 40 years, which compares with 44% for workers in the defined benefit plan for U.S. government civil servants. The 70% replacement rate, however, incorporates the flat social security benefit because of the integration of the benefit formula. The 1.75% per year parameter is multiplied by earnings with an exemption that matches the social security benefit amount.

Final pay is the average of the last two years before retirement. With this short averaging period, the government is concerned about "pension promotions" that occur in the last few years before retirement. These promotions are made primarily to increase the retirement benefits of long-service employees.

Dutch civil servants may retire between the ages of 55 and 65. Mandatory retirement occurs at age 65, but that rule has little effect since nearly all workers retire at a younger age. For workers who leave the civil service before age 55, their pension is indexed during the prereceipt period, which greatly reduces the loss in pension value for workers in comparison to that suffered by those who leave the U.S. civil service and are covered by the CSRS. Also, in comparison to the United States, the retirement conditions are considerably more generous. There is no minimum-years-of-service requirement in the Netherlands.

Since January 1, 1996, the ABP fund has been privatized and has functioned as a private pension fund (Lutjens 1997). Before privatization there was a uniform pension plan for all government employees, including workers in the central government, local government, water control authorities, police, judiciary and education. The Dutch system is much more centralized than that in the United States, where each state and local jurisdiction has a different pension plan, and these jurisdictions usually have different plans covering general service employees, police, firefighters and teachers. Privatization will make it possible for different groups of Dutch employees to negotiate different pension provisions.

The ABP now is regulated by the same law that governs private pension plans in the Netherlands. Thus, this plan is subject to the same regulations governing funding and workers' rights as are occupational pension plans. This is a distinction from the United States, where ERISA, which governs private pension plans, does not regulate the plans for federal government workers and does not provide federal government workers the protections provided to private sector workers.

Privatization has not yet resulted in extensive changes in the Dutch pension plan. A transitional period ended on January 1, 2001. Following that, separate sector plans may be established, and the ABP will have to compete with other insurance companies, as sectors of employees can opt to leave the ABP and choose a private sector insurance company as their service provider. Thus, the statutory monopoly of the ABP will disappear as a result of privatization.

The ABP had until 2001 to prepare for competition. At that point, the ABP was also able to establish separate sector plans for different groups of government workers. It is thought that competition may improve the services provided and reduce the costs of the ABP.

## CONCLUSIONS

The Dutch system provides less risky benefits than are provided to U.S. civil servants, where a significant part of their benefits come from the defined contribution TSP. The U.S. system gives workers more choice concerning their retirement savings but also places more responsibility on the worker. Workers choosing to contribute a small amount to the TSP and investing it conservatively will have lower retirement income than workers in the Netherlands. Workers contributing the maximum to the TSP and investing entirely in the stock market may, however, have significantly more generous benefits than those in the Netherlands, depending on the performance of the U.S. stock market.

In most respects, the ABP plan for Dutch civil servants is more generous than the FERS for U.S. civil servants (see the table). It provides more generous inflation indexing. It is more favorable for workers who wish to leave government employment before the minimum

TABLE

***A Comparison of the Dutch and U.S. Pension Systems for Civil Servants***

| Feature | Netherlands ABP Plan | U.S. Federal Employee Retirement System (FERS) |
|---|---|---|
| Contributions | Employee: 3.3%<br>Employer: 9.9%<br>The first 28,000 guilders a year is exempt (about $14,000). | Employee: 0.8%<br>Government: about 6.7% |
| Eligibility for full annuity | Retirement between ages 55 and 65; There is no minimum years of service requirement. | Age 55 with 30 years of service; ages 55-57 for employees born between 1948-70; ages 60 (62) with 20 (5) years of service. |
| Benefit formula | 1.75% per year of service, times final pay, so that after 40 years the replacement rate is 70%. | Wage base: highest three years average; accrual: 1% or 1.1% at 62 with 20 years service (replacement of 40-44% after 40 years of service) |
| Pension indexation | Benefits in payment indexed to the change in civil servant salaries | None before 62 for most employees; full CPI at 62 if CPI less than 2%; 2%if CPI is 2-3% and 1% below CPI if CPI above 3% |
| Supplementary defined contribution plan | An optional defined contribution plan is available. | May contribute up to 10% of pay with federal matching (automatic 1%) up to 5% |
| Benefit options | All benefits paid as an annuity with survivor benefits | From Thrift Savings Plan: annuity for life or fixed term; lump-sum payment at retirement or death; or may transfer funds to IRA when leaving government |

*Source: 1995 Federal Personnel Guide* and U.S. GAO 1996.

retirement age, and it allows retirement at age 55, while most workers in the U.S. system cannot retire before age 57.

The Dutch plan provides a possible model for further privatization of the plan for U.S. government employees because it is primarily funded through capital markets rather than government securities and because the government pension provider is forced to compete with private pension providers. Both the Dutch ABP plan and the TSP provide examples of the successful government management of funded pensions and, as such, provide possible models for funding of Social Security or the privatization of Social Security. ◀

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