Leasing Retirees: Smart Business or Gaming the System?

By Stephen B. Lawton, Ph.D.

In April 2009, a high school principal in a large Arizona school district met individually with 18 of his most senior teachers to inform them that they would not have a job the following year. Why didn't tenure protect them from wholesale dismissal?

The answer is they all had one thing in common: they were retirees who had been leased or hired back to fill their former positions and were collecting state pensions. It seemed as though they had sacrificed tenure on the altar of mammon.

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Neither the principal, the teachers, nor the school board anticipated this dismal situation when they decided to participate in what is referred to in the United States and Canada as "return to work," "break in employment," "employee leaseback," "phased retirement," "retire/rehire," and "deferred retirement option" plans.

At the time (2007), the economy was booming, the state was growing, and the demand for teachers was insatiable. Taking retirement when one reached the 80 factor (age plus years of experience) and returning to work at a good salary while collecting a pension was a no-brainer. Everyone seemed to win: the teacher had a higher income; the principal retained experienced staff to mentor new teachers; and the district saved on contributions to the pension fund and FICA.

But there's no free lunch . . . at least not forever. And besides, there seemed to be something fishy about the whole arrangement. Articles appeared in newspapers questioning the practice, particularly when senior officials in municipalities, school districts, police departments, and state agencies joined the practice, all seemingly unable to resist the sweet deal offered by the state pension fund that permitted the practice and private firms that touted the benefits (for only a 4.5% fee). As well, there was no doubt that outstanding teachers and leaders were needed and competition from California and Nevada meant that if sweet deals seemed necessary to retain talent, so be it. After all, if employees could double-dip by crossing the state line, why not keep talent at home?

The 2008 fiscal crisis rolled in like a juggernaut across the Arizona landscape. House construction plummeted, foreclosures and unemployed soared, and people stopped moving to the state. In the district in question, enrollment declined, a tax override election failed, revenue linked to sales tax revenue declined, and the state cut funding for discretionary expenditures.

Looking for Solutions

Looking at the options and considering the overall high level of seniority of its teaching staff, the school board decided to preserve the jobs of recent hires and dispense with all rehired retired teachers in order to have a balance of new and experienced teachers. Rehired administrators were retained, however, causing some to quote an alternative golden rule: he who has the gold makes the rules.

On the other hand, senior administrators had already forgone the protection of tenure and were under at-will or term contracts even before they took their pensions. Unlike teachers, they assumed little additional risk beyond what they had when they left teaching for administration.

The effect of the fiscal crisis also took its toll on the Arizona state pension fund, which had declined 27% by March 2009 (Arizona State Retirement System 2009). Although the benefits of retirees were in no danger since the pension fund is a "defined benefit" plan and the state constitution protects the level of benefits, the state is unlikely to let the fund avoid its obligations for pay out. The plan administrators anticipate a series of contribution increases over the next few years to help fill the gap. Most other states face a similar problem, regardless of their policies on rehiring retirees.

When retirees are rehired, the pension trust fund's gap widens because the fund gains no new contributors and loses the contributions from the retirees who are rehired. Also, as Costrell and Podgursky (2008) emphasize, the structure of state teacher pension funds usually creates a peak in the cost of retirements to the fund when employees reach the 80 factor. A person retiring one year earlier costs the fund only the employee and employer contributions, plus interest and any cost-of-living adjustments. The employee's annual benefit is based on the annual payment of an annuity that lump sum can purchase, not the formula that kicks in when an employee reaches the magic number.

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That formula guarantees, in effect, 69% of the employee's final salary after 30 years of experience (30 years × 23% per year) and produces cash flow that requires a much larger lump sum than the contributions and interest alone could produce. Costrell and Podgursky provide an example of the cumulative value of a pension for a hypothetical teacher in Ohio whose pension would have a lump-sum value of $315,000 after 24 years of work. "However, over the next six years she accumulates more than $100,000 per year and crosses the million-dollar mark by age 56" (p. 25).

Thus, a teacher who retires at his or her pension's peak value locks in that value. If the teacher then returns to work and does not contribute to the fund, other younger members must pay more to make up the loss of contribution. In effect, while one teacher double-dips, another is double-hit.

And although the district may save money with a rehire (up to 20% according to an employee-leasing firm), the pension fund itself is invested in bonds and stocks whose value depends on all citizens' ability to pay the interest on bonds and prices charged by firms. The effect of the fiscal crisis on the value of virtually all investments has made it clear that the capacity of consumers and taxpayers is finite.

Benefits and Contributions

Costrell and Podgursky believe the very structure of pension benefits is capricious and creates anomalous situations in which older teachers end up paying to work. That is, after a certain point, the actuarial value of their pension declines more in one year than their annual salary, since the number of years they are expected to live in retirement declines.

Although birth certificates do not indicate expiration dates, actuarial mortality tables suffice for determining pensions' lump-sum values. Educators in this situation would be silly to keep working and paying into the plan, particularly if they have the option to collect their pensions and continue working on a full- or part-time basis.

To restore the link between benefits and contributions, Costrell and Podgursky recommend "cash-balance" pension plans to replace defined-benefit plans. Such a plan would be guaranteed by the employer or state, so the individual would not have the risk associated with 401(k)s or "defined-contribution" plans. Cash-balance plans would prevent the anomalous situations in which teachers can earn more than their salaries with regard to benefits in some years and must pay for the privilege of teaching in others. With cash-balance plans in place, the current financial incentive to engage in retire/rehire would largely disappear.

Other more legitimate incentives for phased-in retirement would still exist. The need to retain some senior employees will not disappear given the demographics in the United States and Canada. Between 2000 and 2020, the percentage of Americans over 65 will rise from 12.5% to 16.6%, a 33% increase; in Canada, the percentage will rise from 12.8% to 18.2%, a 43% increase.

The demographic problem is even more acute in Germany, Japan, and the United Kingdom, where more than 20% of their populations will be over 65. The economies will need older people to work, and many older individuals want to work, at least part time, because of financial need, a desire to be productive and useful, and the need for fellowship (Venning 2004).

A better balance is necessary, though, between the needs and wants of the older generation, especially given the pending retirement of millions of baby boomers and the number of young workers entering the labor force. In an online chat room, one young substitute teacher complains:

> To add to the distress, every time one of the teachers retires they lock up their former building by subbing for all the teachers. Consequently, they rake in the dough and the rest of us sit by and wait for a call . . . and because they don't really need the money, they sub for free for each other whenever they can. GRRRRRR! (Subverted 2009)

The opportunities for jobs vary from state to state, province to province, district to district, and by type of position both within and outside education. The 18 Arizona teachers who took early retirement with the expectation of consistent reemployment in their old jobs seriously underestimated the risk they were taking. Of course, so did many individuals who bid up the price of homes, bought preferred shares in Fannie Mae, or believed, "As goes General Motors, so goes the nation."

As the economy settles into what some are calling the "new normal," pension plans, phased retirement, and other components of nonsalaried benefits for educators and other public and private employees need to be reviewed in light of a nation's economic capacity to sustain them, their effect on the opportunities for workers of all ages, their transparency, and their portability. By not doing so, we risk being faced, in one form or another, with the message the principal delivered that day in April.

References

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