

Illinois Public Pensions

A pension management and investment newsletter for Illinois pension funds published by the Illinois Government Finance Officers Association  Winter 2004

SEC takes steps to address late trading, market timing and related abuses

The Securities and Exchange Commission has taken action on three measures to address late trading, market timing and related abuses in the mutual fund industry.

The Commission voted to propose a **rule requiring that fund orders be received by 4 pm**. Specifically, this proposal would require that an order to purchase or redeem mutual fund shares be received by the mutual fund—or its primary transfer agent or a registered securities clearing agency—by the time that the fund establishes for calculating its net asset value in order to receive that day's price (typically 4 pm for most funds). This rule would effectively eliminate the potential for late trading through intermediaries that sell fund shares. A public comment period concerning this proposal will run for 45 days following its publication in the *Federal Register*.

The Commission also voted to **adopt a compliance rule** that will require funds and advisers to (i) have compliance policies and procedures, (ii) annually review them and (iii) designate a chief compliance officer who, for funds, must report to the board of directors. Designated compliance officers and written policies and procedures will have several benefits, including having a designated person charged with fund compliance who must answer to, and be accountable to, the fund's board of directors, thereby enhancing compliance oversight by directors, as well as allowing the SEC's examination staff to review the reports made to the board. Compliance with this rule will be required no later than nine months after its publication in the *Federal Register*.

Finally, the Commission voted to propose **enhanced disclosure requirements**. These enhancements would require funds to disclose (i) market timing policies and procedures, (ii) practices regarding "fair valuation" of their portfolio securities and (iii) policies and procedures with respect to the disclosure of their portfolio holdings. This type of explicit disclosure would shed light on market timing and selective disclosure of portfolio holdings so that investors could better understand the fund's policies and how funds manage the risks in these areas. A public comment period concerning these proposals will run for 45 days following their publication in the *Federal Register*.

Expensive Firefighter pension bill awaits House action

At press time HB 599 was pending approval by the Illinois House. Visit <http://www.legis.state.il.us> to check the most recent action.

The Illinois Senate approved HB 599 by a vote of 54-1-0. HB 599 provides for a sizable pension increase for dependents of deceased firefighter retirees. The Illinois Economic and Fiscal Commission reports that the bill carries a staggering 5.63% of payroll price tag. This cost estimate is in actuality a blended statewide average cost, meaning that the cost impact experienced by individual municipalities could be far higher.

The bill provides for a 3% annual increase in pensions to surviving children from January 1, 2004 through January 1, 2008 and incrementally increases certain minimum retirement, disability, and surviving spouse pensions. The minimum monthly pension payable to the surviving spouse of a firefighter who died while receiving a retirement pension, including any amount payable on account of children, would increase to 100% of the monthly retirement pension that the deceased firefighter was receiving at the time of death, including any annual increases that have accrued. Currently, the surviving spouse of a deceased firefighter receives a benefit of 54% of salary, plus 12% of salary for each minor or disabled child, without increase. Amends the State Mandates Act to require implementation without reimbursement. If adopted and approved by the Governor, this bill would be effective immediately.

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Salary: The firefighter or police officer's salary (minus what is received from military pay) shall be continued by the employer. If the contributions for the full salary amount are not being paid by the employer or employee, then the fund should notify the employee, upon their return to service, of the amount to be paid.

Creditable service: There is no break in creditable service unless the firefighter or police officer fails to make required pension payments before retirement date.

Non-duty disability: If firefighter or police officer is hurt while on active duty with the United States military, this would be considered a non-duty disability.

For further information please refer to the Illinois Pension Code 40 ILCS 5/3-110(b) for police officers and 40 ILCS 5/4-108(c) for firefighters address these issues.

Firefighters' military service: Creditable service includes military service in the reserves, military, naval or air force of the United States not to exceed five years (exception: a firefighter with more than five years of creditable service on July 1, 1973 shall receive the total amount as of that date). The firefighter must, upon applying for a permanent pension, and in accordance with the board, pay into the fund the amount the firefighter would have contributed if he or she had been a regular contributor during such period, if the municipality for which the officer served, has made no contributions on behalf of the firefighter.

Reference Section 4-108, (c), (1) and (2) for special cases regarding service prior to July 1, 1976.

Police officers' military service: Creditable service includes all periods of service in the military, naval or air forces of the United States, not to exceed five years. (Exception: a police officer with more than five years of creditable service on July 1, 1973 shall receive the total amount thereof as of that date.) This period of service must be entered upon while on active status as a police officer of a municipality. The police officer must, upon applying for a permanent pension, and in accordance with the board, pay into the fund the amount the officer would have contributed if he or she had been a regular contributor during such period, if the municipality for which the officer served, has made no contributions on behalf of the police officer.

Illinois Department of Insurance

Congress authorizes major changes to Medicare

Congress has passed, and the President has signed into law, the Medicare Prescription Drug Improvement and Modernization Act of 2003 (H.R. 1). This sweeping legislation:

- Includes cost containment measures that require individuals with higher incomes to pay larger Medicare Part B premiums.
- Authorizes private sector healthcare providers to compete with Medicare for enrollees.
- Permits the importation of drugs from Canada with certain restrictions.
- Repeals the IRS requirement that debit cards and stored value cards used to pay medical expenses from FSAs and HRAs must report payments on IRS Form 1099 MISC.

In this report, we will concentrate on the two significant changes to Medicare that could affect employer sponsored health plans. These are the establishment of:

- **Health Savings Accounts** beginning in January 1, 2004 providing individuals with another way to pay current and/or future medical expenses
- **Medicare standard prescription drug coverage** available beginning January 1, 2006 and the incentives offered to encourage employers to maintain retiree prescription drug programs.

I. Health Savings Accounts (HSAs)

HSAs are tax-exempt trust/custodial accounts created for the sole purpose of accumulating funds to pay for qualified medical expenses of the account holder, the account holder's spouse or dependents. HSAs expand on the concept of the Archer Medical Savings Account, a pilot program intended to help self-employed individuals and small employers to pay health care costs for employees. Archer MSAs are expected to be phased out at some point in the future and be replaced with HSAs. HSAs may be established by anyone who is enrolled in a high deductible health plan and not entitled to Medicare benefits.

General HSA requirements

What are the HSA Trust requirements?

The HSA trustee/custodian must be a bank or non-bank trustee approved by the Internal Revenue Service as a non-bank trustee. HSA trusts/custodial accounts must meet the following requirements:

- Accept only cash contributions.
- Ensure annual HSA contributions do not exceed indexed family coverage limit plus catch-up limits for the year.
- Not be invested in life insurance policies.
- Must not commingle HSA assets with other assets except in a common trust/investment fund.
- Ensure that HSA account holder is 100% vested in his/her HSA account at all times.
- Treat HSA assets that are used as collateral for a loan as a taxable distribution.
- Terminate the HSA if an account holder has engaged in a prohibited transaction.

What kinds of expenses can be paid with HSA funds?

Expenses for qualified medical care defined under IRC 213(d) for account holder (employee), spouse or dependent defined under IRC 152 may be paid from the HSA. Premiums may not be paid from HSAs, except for:

- COBRA continuation insurance.
- Qualified long term care contracts.
- Health insurance purchased while receiving unemployment benefits.
- Medicare premiums for Medicare enrollees (except for a Medicare supplemental policy).
- Retiree medical premiums under employer-sponsored plan.

Who is eligible to establish an HSA?

HSAs may be established by individuals who are covered under a high deductible health plan (HDHP) and who are not covered under a non-high deductible health plan that provides the same benefits as the HDHP.

Certain types of non HDHP insurance coverages are permitted such as accident, disability, dental, vision and long term care contracts in addition to unemployment insurance, homeowners and auto insurance, specific disease insurance or hospitalization insurance that pays a fixed amount for a specified period of time for hospitalization. Ineligible individuals are those covered under:

- Another non HDHP plan such as a spouse's non HDHP.
- HRAs or FSAs, unless that coverage is limited to dental and vision coverage.
- Medicare.

What are the requirements for a health plan to be an HDHP?

1. Annual deductible (indexed annually) must be at least \$1,000 for self-only coverage or \$2,000 for family coverage.
2. Out-of-pocket expenses (deductibles and co-pays, but not premiums) are indexed annually and must be capped at \$5,000 for self-coverage or \$10,000 family coverage.

Exceptions to limits are:

- Preventive Care plans (Wellness programs) do not have to have a deductible to be considered an HDHP.
- Deductibles and benefits provided under network plans (PPOs) for out-of-network services can exceed \$5,000/\$10,000 cap and still be a HDHP but cannot be used to increase contribution limits.

Contributions

Who may contribute to an HSA?

Eligible individuals, employers and/or employees. Eligible individuals may contribute to their HSAs. Family members may also contribute to HSAs of other family members. Employers may contribute to HSA accounts for eligible employees through a cafeteria plan. Employees may contribute to an HSA through a cafeteria plan on a pre-tax basis under a salary reduction agreement.

What are the annual contribution limits?

Dollar limits will be indexed annually. The 2004 limit is the smaller of the:

- Annual deductible amount or \$2,600 for self-only coverage.
- Annual deductible amount or \$5,150 for family coverage.

All contributions to an Archer MSA and other HSAs must be aggregated when applying contribution limits.

Are catch-up contributions available?

Catch-up contributions are available to individuals between the ages of 55 (by the end of the calendar year) and 65. Annual contributions may be increased by \$500 in 2004; \$600 in 2005; \$700 in 2006; \$800 in 2007; \$900 in 2008; \$1,000 in 2009 and thereafter.

Can HSAs accept rollovers from other plans or be rolled into other plans?

HSAs can accept rollover contributions from Archer MSAs and other HSAs. HSAs may be rolled to other HSAs

AROUND THE STATE

In this new section we will take a look at how public pensions are perceived throughout Illinois. If you have an article to share, please forward it to mshank@igfoa.org.

Chicago Tribune reports: “Governor considers trimming state’s funding for retirement accounts”

On January 31st, the *Chicago Tribune* reported that Gov. Rod Blagojevich is now considering scaling back spending on the state’s massive pension plans and that the governor may also ask public employees to chip in more for their retirement accounts. State of Illinois Budget Director John Filan was quoted as saying the administration would consider asking its large unionized workforce to pick up employee pension contributions that the state now covers, a perk worth about four percent of a worker’s pay.

As part of that report, the *Tribune* noted, “Aggravating the budget woes is a recent determination by state pension officials that an early retirement program set in motion by former Gov. George Ryan as an economy measure was so overly generous that long-term savings—if there are any—could be negligible.

When it began, the retirement program was projected to slash payroll costs even though it expected to add \$70 million a year to the state’s pension obligations. In fact, thousands more employees took advantage of the program than expected, and revised state estimates show the added pension obligations will amount to \$380 million annually for the next nine years.”

Peoria Journal Star says: Public pension monster eating into city services *reprinted from the Peoria Journal Star*

The Peoria City Council tamed its 2004 budget last week, but the council can’t tame the monster that keeps demanding more and more of the city’s resources. That monster, which plows no streets, arrests no criminals and fights no fires, is the growing cost of city pensions. Consider these figures:

► The owner of a \$100,000 Peoria home pays \$316 in real estate taxes directly to the city (library tax excluded). Of that, \$150—47 percent—is for pension payments. And

it’s not enough. In the coming year the city will have to come up with \$1.2 million beyond the earmarked pension tax proceeds to meet its obligations. It learned of the new demand late in the fall, precipitating another budget crisis.

► The city will spend \$7.9 million next year for pensions. That amount would pay the salaries of more than 150 firefighters or police officers. Only three city departments—police, fire and public works—spend more. For \$7.9 million, the city could run its finance, treasurer’s, legal, human resources, economic development, planning and inspections departments. All of them.

► The retirement funds for city police officers and firefighters alone carry an unfunded liability of \$47 million. City taxpayers can expect to play catch-up for 30 years at extra annual payments of well over \$1 million.

Peoria isn’t the only city in the state with a pension crisis, and there is one big reason why. For the most part, cities can’t decide what pensions they can afford to pay. State lawmakers, who do not pay the bills, decide it for them. And here is what they have decided:

► Police officers and firefighters can retire at half pay when they are 50 years old, after 20 years of service. Those who work 30 years will receive 75 percent of their last salary.

► Retirees will get a cost-of-living raise each year.

► Their survivors will get benefits as long as they live.

“Police and fire have a gold-plated pension system,” said Joe McCoy, a legislative assistant with the Illinois Municipal League. Indeed, few employees in the private sector enjoy such lucrative retirements. Many Peorians who pay for these pensions have none of their own. It’s true that city employees earn and deserve pensions; no one should begrudge them that. It’s true that cops and firefighters have dangerous and physically demanding jobs, and not all can work into their sixties. It’s also true that they contribute a portion of their salaries (police 9.9 percent, firefighters 8.5 percent, office workers 4.5 percent) to help fund their pensions. But taxpayers carry most of the load, and that load is growing so much more rapidly than the rate of inflation that higher taxes and sharp cuts in services can only result. Unless things change quickly, taxpayers will be asked to bear more.

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Public pension monster

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Almost every year the General Assembly tweaks one pension system or another, sweetening retirement pay at local expense. From 2000 to 2001, Peoria's costs went up \$300,000 because of pension law changes. In 2003 expenses rose \$400,000 when the Legislature cut the time of service for police to receive a maximum pension from 35 to 30 years. At the same time the same Legislature was cutting state aid to cities on the grounds that Illinois didn't have the money. Well, here's a news flash: cities don't have it either.

You would think, wouldn't you, that legislators would be listening to city officials who say the pension burden is breaking them. And you would think legislators from this area would respond.

You would be wrong.

Last spring State Sen. George Shadid of Edwards and Rep. Mike Smith of Canton led an effort to increase pension benefits—again. The legislation would nearly double what widows of firefighters get. Minimum monthly pensions would increase. And surviving children would get more, too. No other public pension system in the state would have such generous benefits for all survivors. The legislation would increase pension liability in municipalities statewide by \$232 million and require them to come up with an extra \$18 million annually. The cost of the new benefits to Peoria alone likely would be several hundred thousand dollars a year.

What happened to the bill? It passed the State House without a single negative vote. It is awaiting action by the State Senate.

So what can these legislators be thinking?

Smith says he's thinking the bill will give firefighters' widows the same benefits police widows already have. Asked about the wisdom of increasing the terrible load on cities, he said the Municipal League and the firefighters union have some negotiating to do before the pension hike is passed.

No, they don't. There is nothing to negotiate. Of all the irresponsible things the Legislature might do, high on the list would be to burden cities with more pension costs.

If Shadid and Smith want to do right by the taxpayers who voted them into office, they will propose a moratorium on pension increases for all public employees. They will urge appointment of a panel to study public pensions and recommend levels that will be fair and affordable over the long run. Better yet, they will ask that panel to tell them why cities, counties and school districts shouldn't be free to decide for themselves what size pensions they can pay. What business is it of the Legislature's, anyway?

Changes to Medicare

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tax-free if HSA funds are rolled over to another HSA within 60 days of receipt of funds. Only one rollover is permitted in any 12-month period.

NOTE: Unless later guidance to the contrary is issued, it is likely that IRA direct transfer rules will apply to HSAs, which would permit HSA funds to be directly transferred from one HSA trustee to another HSA trustee without limiting the number of transfers in any period.

Are annual HSA limits reduced by rollover contributions?

No, rollovers into HSAs do not affect annual HSA contribution limits.

How are excess contributions to an HSA treated?

Excess contributions and earnings to an HSA are included in gross individual's gross income and may be subject to excise taxes.

- Contributions and earnings returned after tax filing deadline will be subject to both income tax and the excise tax.
- Excise taxes will not apply if contributions and earnings are returned prior to the HSA holder's tax filing deadline.

What happens to HSA funds not spent in a tax year?

Unused HSA funds are carried over from year to year. Individuals with current qualified medical expenses may choose to pay these expenses themselves and let HSA funds accumulate for future medical expenses.

Taxation and reporting requirements

How are contribution and accumulations taxed?

Contributions made by individuals to their HSAs are tax deductible on their personal tax returns even if they do not itemize. Contributions and earnings accumulate tax-free.

Employer contributions and salary reduction contributions to a cafeteria plan are not subject to federal income taxes or FICA taxation and accumulate tax-free.

How are HSA distributions taxed?

Distribution for qualified medical expenses is tax-free.

Non-qualified distributions will be included in gross income and subject to 10% excise tax. Excise taxes are waived for death, disability of HSA accountholder.

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Changes to Medicare

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What happens if account holder changes jobs or re-tires?

HSA's are completely portable (like IRAs) and may be rolled/transferred to other HSA's on tax-free basis.

How is the HSA taxed if the HSA account holder dies?

If designated beneficiary is the surviving spouse, ownership of the HSA can be transferred to the surviving spouse on a tax-free basis.

If designated beneficiary is not the spouse, HSA account will no longer be an HSA and HSA assets will be included in income of beneficiary. If there is no designated beneficiary, HSA assets will be included in decedent's estate.

What happens to HSA assets in cases of divorce?

HSA assets may be transferred to the alternate payee-spouse in a non-taxable transfer.

II. Voluntary prescription drug benefit program

The second major change to Medicare is the establishment of a voluntary prescription drug program beginning January 1, 2006 and the subsidies paid to employers for retirees who do not use the new Medicare prescription drug program. The purpose of the subsidy is to encourage employers to maintain current employer-sponsored retiree prescription drug programs.

Who is eligible for the Medicare Voluntary Prescription Program?

Individuals enrolled in Medicare Part A or eligible for Medicare Part B may voluntarily enroll in this program.

How much will an enrollee in the Medicare standard prescription drug program have to pay?

- Average Monthly Premium is estimated to be approximately \$35/month.
- Annual deductible of \$250.
- 25% co-payment for drug expenses from \$251 to \$2,250.
- 100% for drug costs between \$2,251 and \$3,600.
- 5% co-payment (catastrophic coverage) for out-of-pocket expenses above \$3,600 including deductibles and other costs (but not premiums).

No deductibles or monthly premiums and reduced co-payments are available to qualified low-income individuals. All dollar limits will be adjusted annually.

What are the requirements for employer subsidies maintaining their own retiree prescription drug programs? How much is the subsidy employers could receive?

To receive tax-free subsidies public and private sector employers will have to:

- Sponsor retiree prescription drug programs that are the same as or the actuarial equivalent of the standard Medicare prescription drug program (stated above).
- Have retirees who do not enroll in the Medicare voluntary prescription drug program.

Employers will receive a 28% tax-free payment for the actual net cost of a retiree's prescription drug expenses from \$251 up to \$4,750. Maximum subsidy could not exceed \$1,338 per retiree.

Employers will be required to file reports and keep detailed records, which may be subject to government audits.

Reprinted from Nationwide Retirement Solutions December 2003 newsletter. Contact Paul Mollmann, State Director at 847-869-1843 or mollmap@nationwide.com

State Pension Laws Commission abolished

Public Act 93-0632 (SB 1656) abolished the Pension Laws Commission and transfers all of the duties of the commission to the Illinois Economic and Fiscal Commission, effective February 1, 2004. The actual physical transition occurred on January 5, 2004, as the volume of pension bill introductions and the overall workload in early February is extremely high.

The Economic and Fiscal Commission will be responsible for preparing pension fiscal impact notes for the State Legislature. It can be reached at: Illinois Economic and Fiscal Commission, 703 Stratton Office Building, Springfield, IL 62706; phone 217-782-5320.

A FOCUS ON BASICS

Total portfolio management

by Mark F. Toledo, CFA

The investment management process begins with the identification and understanding of long-term investment objectives that are both realistic in the capital markets and appropriate for the portfolio. These objectives lead to the development of a set of asset allocation targets that form the foundation for a sound investment policy. The ongoing process of consistently and continually committing to the implementation of the investment policy then becomes the critical determinant of whether or not the portfolio achieves superior investment results.

A combination of quantitative and qualitative analysis of historical results produced by various asset classes can be used to determine the appropriate set of strategic targets for the portfolio. The next step in the process is to determine whether active or passive approaches should be used for the management of the securities in each asset class. Experience shows that relatively passive approaches to traditional fixed income and large cap equity securities are appropriate, because these securities trade in efficient markets. Trustees can then select active portfolio managers for less efficient markets, such as small cap equities and real estate. The selection of superior active managers begins with the identification of firms with superior long-term historical results based on consistently employed investment disciplines.

Figuring out the optimal investment policy and the judicious use of active versus passive managers within each asset class is easy compared to sustaining a long-term commitment to the policy and managers. The hardest work in investing is emotional, not intellectual, because being rational in an emotional environment is not easy. The emotional tendency is to become more comfortable with a higher level of equity exposure in a bull market and less comfortable in a bear market.

Successful investors are able to manage these emotions and stay committed to their long-term policy by reallocating assets at market highs or market lows to remain committed to their policy. Portfolios should be periodically rebalanced to the benchmark asset class allocations to control risk, by reversing deviations from policy that result from asset class performance differentials. Disciplined rebalancing techniques provide the basis for creating portfolios that reflect the articulated risk and return characteristics over time that are consistent with the policy.

Successful investors also recognize that extraordinarily strong performance by an active manager within the asset class likely stems from a combination of manager skill and market conditions. Following periods of greater-than-expected performance, you should consider reducing the manager's account size. Reducing the account of an out-

performing manager and reallocating funds to weaker performers, whose style has been out of favor, will likely improve long-term performance.

What does this article mean for you today? First, check your current asset allocation to see if it matches up with your long-term policy benchmarks. You may find that after a three-year bear market for stocks and a three-year bull market for bonds that a reallocation from bonds to stocks is necessary to bring the portfolio back in line with policy targets. Second, do not become overly confident with your active investment managers that have achieved superior relative results over the last twelve months. You may need to reallocate funds from a value style to a growth style of equity portfolio manager to re-establish your desired mix. Additionally, you should consider reallocating funds from bond managers that have been successful with a portfolio of long-term bonds to an intermediate term portfolio to maintain the desired roll of bonds in your portfolio.

An appropriate long-term investment policy, the judicious use of active and passive managers, and periodic rebalancing of the portfolio to the benchmark targets will provide you with a greater chance of meeting your investment goals.

Mark Toledo is President, Total Portfolio Management, LLC. He can be reached at 312-218-5754 or by email at marktoledo@comcast.net; on the web at www.totalpm.net



Illinois Public Pensions

Editor: Marianne Shank, Executive Director, IGFOA
Volunteer Editor: Eric Dubrowski, Finance Director, City of Galena

Illinois Public Pensions is published quarterly by the Illinois Government Finance Officers Association (IGFOA), Suite 202, Westmont Center, One S. Cass Ave., Westmont, IL 60559; phone 630-663-0019, www.igfoa.org.

Annual subscription rates are:

Public Sector IGFOA member rate – \$35 plus \$1 for each additional newsletter to same subscriber

Associate IGFOA member rate – \$50 per year/subscriber

Public sector non-member rate – \$100 per year/subscriber

Private sector non-member rate – \$100 per year/subscriber

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Illinois Public Pensions

Illinois Government
Finance Officers Association
Westmont Center Suite 202
One S. Cass Ave.
Westmont, IL 60559
www.igfoa.org
630-663-0019

Winter 2004 Issue

Early retirement incentives tips and traps

by **Nicholas Greifer, GFOA**

The October 2003 **Government Finance Review** included an article titled "Squeezing Budgetary Savings from Early Retirement Incentives" that offered the following **Tips and Traps** when considering an early retirement program.

Governments contemplating the use of early retirement incentives as a gap-closing tool can profit from the experiences of governments that have already offered such incentives. GFOA studied several of these governments to learn what works and what does not. These lessons are presented below as tips and traps.

Tips

- Be clear about program objectives. Whether the primary objective is budgetary or human resources in nature will determine how success is defined and measured.
- If budgetary savings are the primary objective, first consider other potentially more effective gap-closing alternatives to early retirement incentives.
- Use performance measures, both during and after implementation, to determine the effectiveness of early retirement incentives.
- Conduct an actuarial analysis to determine the projected increase in the annual required contribution, the principal cost of an ERI program.
- Compare projected savings to actual audited savings.
- Track global staffing levels to avoid "leakage" in savings (if budgetary savings are the primary objective).
- Use early retirement incentives sparingly. To deter employee expectations for new incentives, consider a minimum five-year cooling off period between ERI windows.

Traps

- Failing to plan for service disruptions after key employees retire.
- Offering excessively broad eligibility requirements for early retirement incentives.
- Assuming slow salary growth for replacement employees whose salaries tend to quickly ramp up.
- Timing the window incorrectly. If budgetary savings are the primary objective, lock in the savings for one year rather than straddle fiscal years. Also, recognize that there is a lag in savings such that the budgetary impact may not be realized until after the ERI program has ended.
- Assuming long-term savings and short-term costs. Both the costs and the savings of an ERI program should be analyzed and recognized over a short period of time (e.g., five years). Done correctly, early retirement incentives can be an effective technique both for closing budgetary gaps and for achieving organizational efficiencies. Done incorrectly, they can fall short of budgetary goals, cause unintended service disruptions, and saddle taxpayers with long-term cost increases. Using a disciplined budgetary approach and applying the lessons learned by other entities can go a long way toward helping governments achieve a successful early retirement window.

NICHOLAS GREIFER is manager, policy analysis, in GFOA's Research and Consulting Center in Chicago.

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