Defusing the Pension Bomb: How to Curb Public Retirement Costs in New York State

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EXECUTIVE SUMMARY

Skyrocketing state and local employee pension costs have been a major factor in the fiscal crisis affecting every level of government in New York State. Taxpayer financed public pension contributions have soared by more than $2.3 billion dollars over the past two years—and are projected to rise even more in 2004. In New York City alone, the rise in pension costs will consume every dollar raised by Mayor Bloomberg’s record property tax increase.

The defined benefit (DB) pension plans used by state and local governments guarantee employees a fixed percentage of retirement income based on their peak salaries and career longevity. This requires those governments to invest money each year to cover future pension payments. But their contributions vary depending on complex actuarial assumptions and market fluctuations. As a result, the DB system is crisis prone because earnings during bull markets cover employer contributions, while losses during bear markets force governments to drastically increase contributions. Since bear markets usually coincide with recessions, DB pension plans force governments to spend more when they are least able to afford it.

This study shows how greater fairness for New York taxpayers and better retirement benefits for the majority of government employees can be achieved by switching from the current defined benefit (DB) pension plan to the defined contribution (DC) model used by the vast majority of private companies. A DC plan differs from a DB plan by requiring employers to contribute the same amount in bear and bull markets and by giving employees ownership of, and investment responsibility for, their own pension funds. A DC plan offers increased retirement equity and flexibility for the majority of public employees while providing predictable costs for taxpayers and government employers.

Under the plan proposed here, employees would be required to contribute at least 3 percent of their salaries to a retirement account. The government would match this with a minimum contribution of 5 percent, bringing the total minimum retirement savings to 8 percent of salary per year. Employers would match up to 2 percent of additional employee contributions, so that retirement savings of up to 12 percent of salary would consist of up to 7 percent from the employer and 5 percent from the employee. The recommended DC plan would effectively cap costs at 7 percent of pay, just over half the fiscal 2004-05 employer contributions for the New York State and Local Retirement System.

Taxpayers would no longer bear the risks associated with market downturns. Public pension costs for the first time would become both predictable and easily understandable, and the real costs of proposed benefit increases would be completely transparent, rather than obscured by complex actuarial calculations.
ABOUT THE AUTHORS

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Introduction

Skyrocketing pension expenses have been a major factor in the fiscal problems afflicting every level of government in New York State. Statewide public pension contributions have soared by more than $2.3 billion over the past two years—and are projected to rise even more in 2004. In New York City, the spike in pension costs has been enough to consume nearly all of the revenue raised by a record property tax hike.

Today’s resurgent pension obligations represent a return to historical norms after an unprecedented period of declining costs during the 1990s. A significant added infusion of tax money will be needed to make good on New York’s generous retirement promises to its public employees for many years to come.

The pension problem is not simply a function of the recent stock-market slump or increases in pension benefits, although both helped precipitate the latest crisis. The real cause is the fundamental design of the pension system itself, which obscures costs and wreaks havoc on long-term financial planning.

Precisely for this reason, merely tinkering with existing retirement formulas will not be enough to head off another wave of higher pension contributions for government employers. Because the New York State Constitution does not allow pension benefits to be “diminished or impaired” for current public employees, nothing can be done to reverse the recent run-up in pension costs. But this system, which contributed to a previous budgetary meltdown in the Empire State,¹ will remain a ticking fiscal time bomb if it remains unchanged.

Only by bringing its outmoded, early 20th century pension structure into the 21st century can New York make pension costs more transparent, predictable and controllable. This modernization can be accomplished by shifting from the state’s current defined-benefit pension entitlement to a defined-contribution retirement savings plan for government employees.

This change would save money in the long run. At the same time, a personalized, savings-based pension would provide employees with benefits that are flexible, portable—and comparable to those offered by most private-sector retirement plans.

By acting now to reform government pensions in a way that protects the interests of both employers and employees, farsighted public officials can make real progress in bringing these costs permanently under control—before another generation of New Yorkers must wrestle with the consequences.

Pension Instability = Higher Taxes

The last few years have seen a dramatic turnabout in public pension costs in New York State. As shown in Figure 1 on the following page, pension obligations began to rise after state tax revenues began to decline. (A similar trend is affecting New York City, which administers separate pension funds.)

Despite massive tax increases, New York State’s total tax receipts have yet to recover to 2001 levels. But pension costs in fiscal 2004 will be nearly five times higher than they were three years earlier.
And the worst is yet to come. As shown in Figure 2, pension contribution rates by New York State and New York City government employers will rise sharply in 2005. These trend lines translate into literally billions of dollars in added obligations.

As Figure 2 shows, the Comptroller is requiring state and local governments outside New York City to contribute 12 percent of the employee payroll in fiscal year 2005 just to meet existing pension obligations. Pension contributions in New York City’s separate retirement system, measured on a slightly different basis, are even higher. This situation highlights a persistent, built-in shortcoming of the current retirement system: it tends to demand more money when the government can least afford it.

The problem with public pension plans

In New York, as in nearly every other state, public employees belong to defined-benefit (DB) pension plans. Under such plans, all workers are promised a stream of post-retirement income based on their peak salaries and career longevity. These payments are financed out of common pension trust funds, invested mainly in stocks and bonds. The funds are administered by government and supported primarily by employer contributions.

The percentage of employee salaries that employers must contribute to the pension fund is based on actuarial assumptions concerning the number of active and retired workers; the projected salaries, pensions and life expectancies of retirement system members and their beneficiaries; and, last but not least, the current and projected rate of return on pension fund investments. Retirement systems are considered fully funded when they keep enough money on hand to meet all current and future pension obligations.

When a DB pension fund’s investments earn a larger-than-projected return, the required employer contribution to the fund decreases. Conversely, when the rate of return falls short of projections, employer contributions must increase to make up the difference. Since stock markets often decline during recessions, DB plans require governments to spend more money on pensions when unemployment is up and revenues are down—exactly when they can least afford it.
This pattern has particularly dire implications for New York, which is much more dependent on revenues from the stock market than most other states. It makes it even harder for New York to weather economic downturns without raising its already high taxes, which in turn depresses the state’s economy and harms its business climate.

The right solution

How can the cost of New York’s public employee retirement plans be made more predictable and affordable without depriving workers of the benefits they need?

The answer lies in switching from the defined-benefit pension plan to a defined-contribution (DC) model. Instead of a single common retirement fund, a defined-contribution plan consists of individual accounts supported by employer contributions, usually matched at least in part by the employees’ own savings. These contributions are not subject to federal, state or local income taxes. Funds in the accounts are managed by private firms and invested in a combination of stocks and bonds.

A key difference between the two types of plans has to do with timing: Under a DB system, the employer promises to finance a future retirement benefit for a large group of current and former workers. Under a DC system, the employer promises to make current contributions to the retirement accounts of each employee. The size of the ultimate retirement benefit generated by a DC plan depends on the amount of savings and investment returns the worker is able to accumulate over the course of his or her working life. The downside risk of unanticipated investment losses and the upside potential for unanticipated investment gains are both shifted from the employer to the employee.

The most common example of a defined-contribution plan is the 401(k), which has become the backbone of the retirement planning for many private sector workers. Such a plan is not unheard of in the public sector—it is now being phased in as the sole pension for state government employees in one major state (Michigan) and as an option in another (Florida). A defined-contribution plan also has been the retirement vehicle of choice for most employees of public higher education systems throughout the country, including the State University of New York (SUNY) and the City University of New York (CUNY).

The financial plus for taxpayers

Over the long term, shifting all civilian public employees to a DC plan in New York State would steadily reduce taxpayers’ pension funding obligations to just over one-half the “normal pension cost” projected by the state comptroller.2

The DC plan recommended by this report could deliver competitive retirement benefits within a fixed and predictable cost envelope of 5 to 7 percent of total salaries.3 In current terms, compared to projected 2004-05 pension contribution levels, that would represent an annual savings of more than $600 million for New York City alone—and nearly $1 billion for the state and other local governments.4

At normal turnover rates, roughly half the state and local workforce, not including police and firefighters, would be covered by the new plan within 10 years.5 A sizeable majority would be in the DC plan within 25 years.6 This transition would make a significant dent in public pension obligations during inevitable future downturns in the stock market and tax revenues. It would also greatly simplify financial planning for governments.

Such a plan will also result in equivalent or improved retirement benefits for many if not most government employees. As shown on pages 7–10, employees who spend only part of their careers with government receive much higher pensions with a DC plan, while career, senior-level employees can do just as well if they contribute slightly more than required to their plans.

Like so many other issues, the urgent need to deal with the rising cost of public pensions in New York boils down to a question of equity. Does the current system strike the right balance between the interests of taxpayers and of public employees? To arrive at an answer, it’s necessary to review the structure of the current system and to compare its cost and benefits to those of other public and private retirement plans.
PUBLIC PENSIONS IN NEW YORK

There are eight different retirement systems for government employees in New York State, organized along jurisdictional and occupational lines as shown in Appendix A.

Taken together, New York’s public pension pools hold over $250 billion in stocks, bonds and other financial assets in support of retirement benefits for current and past government workers. In 2002, pension payments to roughly 600,000 New York state and local government retirees and their beneficiaries totaled over $12 billion—an amount that exceeded the entire state government payroll.

Details vary, but all state and local public pensions in New York share certain basic characteristics:

- Employees are promised fixed retirement payments based their number of years worked and an average of their highest salaries.
- The benefit structure is designed to favor long-term career employees.
- Employee contributions to the common pension funds, for those still required to make them, are comparatively small. Most employees do not have to make any pension contribution.
- Employees receive a right to pension payments (“vest”) only after five years on the job. People who leave before that receive nothing, beyond the right to withdraw their own pension contributions.
- An employee’s pension benefits at the time of hiring are guaranteed by the state Constitution and, when paid out, are exempt from New York State and New York City income tax.

Trail of “tiers”

New York’s public pension plans are organized into benefit “tiers” based on hiring dates, as follows.

- **Tier I** benefits are available to all employees who landed on a participating government payroll before June 30, 1973;
- **Tier II** covers all employees hired between June 30, 1973 and before July 27, 1976;
- **Tier III** covers employees hired between July 27, 1976 and before Sept. 1, 1983; and
- **Tier IV** includes all employees hired since Sept. 1, 1983.

The cutoff dates for each tier reflect the recent history of legislative attempts to control runaway government pension costs in New York.

The most generous pension plan is Tier I, which requires no employee contribution and allows unrestricted retirement with full pension as early as age 55. Significantly, Tier I does not cap the final average salary (FAS) used as a basis for computing the pension. Thus, compared to employees hired after 1973, Tier I members have more ability to significantly pad their pensions by working additional overtime in the year or two before retiring.

Tier II, enacted as fiscal storm clouds were gathering around New York in the early 1970s, raised the basic retirement age to 62. Retirement at age 55 with the maximum pension is still allowed for Tier II employees, but is restricted to those with at least 30 years of service. Pensions are reduced for those with fewer than 30 years in the system who retire between the ages of 55 and 62. In addition, the definition of salary used to compute pensions is subject to a cap. Like Tier I, Tier II requires no employee pension contribution.

The creation of Tier III, during the darkest days of the New York City fiscal crisis, marked the first time most state and local employees in New York were required to kick in some of their own money—3 percent of salaries—towards their future retirement benefits. The retirement ages are basically the same as in Tier II, but the cap on final average salary is slightly lowered.

For the first 16 years after its enactment, Tier IV also required a 3 percent employee contribution. This tier also initially featured more restrictions on early retirement. However, pension benefits and eligibility rules are now virtually identical under Tiers III and IV.

Under pension enhancements passed in 2000, Tier III and IV workers outside New York City, and most civilians in city pension plans as well, are no longer required to make pension contributions after 10 years of government employment.

Carving out special benefits

Over the years, various public employee unions have successfully lobbied the state Legislature to create special plans for specific employee groups within the
tier structure, such as sheriffs, corrections officers and teachers. As a result, Tier IV alone also encompasses 11 separate retirement plans.

Putting aside the often bewildering array of retirement options available under these different plans, virtually all Tier III and Tier IV employees who have attained the five-year “vesting” point can retire from government service and start drawing at least a partial pension as early as age 55, with full benefits at 62. Civilian retirees with fewer than 20 years in the system receive 1/60 of their salary (1.67 percent) for each year of service. Those with 20 to 30 years receive 1/50 of salary (or 2 percent) for each year. For each year of service over 30 years, the pension includes an addition 3/200 (1.5 percent) of final average salary.

In practice, these rules mean the basic pension for a 30-year employee of the state system is at least 60 percent of final average salary, rising to 75 percent for a 40-year employee. When federal Social Security benefits are added to the mix, many career New York State and local government employees can retire at more than 100 percent of their final salaries.

Police and fire

Police officers and firefighters throughout New York are grouped into two pension levels—Tiers I and II—both of which offer more generous benefits, in some respects, than those available to civilian employees. Members of the police and fire pension systems can retire at half pay after just 20 years on the job, with no age restriction. As a result, most New York cops and firefighters who are not promoted to a supervisory ranking choose to begin second careers in their early 40s, backed up by pensions often swollen by overtime in their pre-retirement, peak earning years. (In 1992, retirement at half pay after 20 years was also extended to New York City sanitation workers.)

Members of the New York State Police and Fire Retirement System, which covers agencies outside New York City, are not required to make any contribution towards their own pensions. In New York City, employee contributions to the police and fire pension funds are determined by age and experience. However, these pension contributions are partially to fully covered by special added pay allowances from the city.

Pensions as a security blanket

Public sector pensions in New York are structured to provide most career government employees with the ultimate in financial security—the guaranteed prospect of retiring at a relatively early age with little or no net decrease in income. For police and firefighters (and, most recently, New York City sanitation workers), the pension system provides a financial platform for embarking on a second career in middle age.

Such generous provisions are not uncommon in other states and the federal government—but they are unheard-of for the vast majority of private sector workers who pay government’s bills.

PUBLIC AND PRIVATE PENSION TRENDS

Just over half of all private sector employees (53 percent) participated in any employee-sponsored retirement income plan as of 1996-97, according to a data compiled by the Employee Benefits Research Institute. Among those private workers who did participate in such a plan, the vast majority were in defined-contribution accounts, such as 401(k)s, to which employers usually contribute. Roughly one-quarter of private sector workers (27 percent) in 1996-97 had any stake in a defined-benefit pension plan. DB pension plans are typically found in large, old-line industrial companies—most of which are struggling to limit backbreaking pension obligations.

Prompted initially by changes in federal tax and employee benefit laws starting in the late 1970s, the shift to DC plans picked up more momentum as a long bull market commenced on Wall Street in the 1980s. Steven A. Kandarian, executive director of the Pension Benefit Guaranty Corp., which insures private pension plans, summarized the factors driving employers towards DC plans in recent congressional testimony:

“Increased competitive pressures ... have led companies to reexamine their entire cost structure. In the 1990s, companies noticed that many workers did not place a high value on their defined-benefit plans, compared to the value they placed on their 401(k) plans. Furthermore, companies became concerned that their financial obligations to defined-benefit plans were highly
volatile, in part because of fluctuations in interest rates and a dependence on equity investment gains. This volatility can make business planning difficult. As a result, many companies have been increasingly unable to afford, or unwilling to maintain, defined-benefit plans. In addition, companies found that demographic trends have made defined-benefit plans more expensive. With workers retiring earlier and living longer, plans must pay annuities for far longer. Today, an average male worker spends 18.1 years in retirement compared 11.5 years in 1950, an additional seven years of retirement that must be funded."

Each of the corporate concerns cited in Kandarian’s testimony could apply with equal force to New York State, New York City and other large government employers.

In recent years, two major states have joined the DC trend on a broad scale, while the one state with a DC plan has moved towards a hybrid DB option.

Michigan leads the way

Under the leadership of then-Governor John Engler, Michigan became the first large state to shift from a DB plan to a comprehensive DC plan in 1997. In the DC plan, the state contributes a minimum of 4 percent of each worker’s salary to an individual investment account and matches voluntary employee contributions up to an additional 3 percent of salary, making a total contribution of 10 percent. Additional employee contributions up to 13 percent of salary are allowed, but are not matched by the employer.

The employer’s contributions are considered partially vested after two years and fully vested after four years. The “unvested” portion of the state’s contribution is not included in the permanent account a worker can transfer to another employer’s retirement plan before the four years is up.

Michigan’s DC plan was mandatory, replacing the previous DB plan, for all employees hired after the March 1997 effective date. Those already in the system at that time were given a four-month window to shift past employee contributions and the discounted “present value” of their accumulated retirement benefits to a DC account. In the limited time available, with unions running a campaign opposed to the change, only 3,600 out of 58,000 workers, according to the Michigan Office of Retirement Services, opted to join the DC plan.

Counting new workers, however, the DC plan has grown over the past few years to 18,500 members, 30 percent of the total workforce of 61,500. At this turnover rate, most Michigan state employees should be in the DC plan by 2017.

Florida Follows Suit

Unlike Michigan, Florida did not convert entirely from a DB to a DC plan. Instead, in 2000, the Florida Legislature voted to create a defined-contribution plan as an alternative to the existing DB state plan.

Like the existing DB plan, the new defined-contribution account is non-contributory for the worker. Government employers contribute to personal accounts at a rate of 9 percent of each worker’s wages.

The Florida DC plan includes a vesting requirement of only one year. After that time, workers have full property rights in the personal account funds and can take those funds with them to any other job. Past service in the Florida Retirement System (FRS) for current employees counts toward this one-year requirement.

As of July 2003, only 4 percent of state and local employees who already belonged the FRS had opted into the new DC plan. Among new employees, the opting-in rate was 8 percent. As state officials subsequently acknowledged, their timing was terrible: “During the education and choice periods, employees were exposed to an economic recession, plummeting stock market, negative press accounts of the dangers of 401(k) plans and the aftermath of the September 11, 2001 terrorist attacks and the largest corporate bankruptcy in U.S. history.”

In addition, as in Michigan, state employee unions mounted a campaign urging members not to switch.

Until Michigan’s reform, Nebraska was the only state to exclusively offer a DC plan to a broad segment of its public employees. But the Nebraska plan, which has covered state workers since 1964, recently has
been augmented by a new cash-balance plan that is a hybrid of DC and DB models.¹⁹

Federal pension reform

For all employees hired after 1984, the federal government’s defined-benefit pension for civilian workers was replaced by a system that combines a small DB pension²⁰ with a DC pension known as the Thrift Savings Plan (TSP). In TSP, federal agencies will match up to 5 percent in employee contributions, measured as a percentage of pay. On top of that 10 percent, employees can contribute an extra 5 percent a year without a government match.

Higher education precedent

New York and many other states allow their public college and university employees to opt into defined-contribution plans.

The choice has been available to SUNY employees for nearly 40 years. Over 85 percent choose a DC plan, such as the one offered by New York-based Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF). Employees contribute 3 percent of salary; the employer contribution in the SUNY system is 8 percent a year during an employee’s first 10 years, and 10 percent thereafter.

CUNY also offers its employees a DC option, managed exclusively by TIAA-CREF.

COMPARING THE PENSION ALTERNATIVES

As explained on pages 1–3, moving to a defined-contribution plan clearly would represent a better deal for state and local government—and the taxpayers who ultimately foot the bill—while having no effect on current employees, who are constitutionally locked into the DB system. But what would it mean for employees who would be covered by such a plan in the future?

To illustrate the comparative benefits of DB and DC plans, consider two sets of hypothetical state workers and the benefits they could expect under both plans.

The first set of examples consists of workers who leave the state pension system 10 to 20 years into their working lives. Such “early-career” state employees have the most to gain from a DC system. This is because such workers never reach the peak earning years that are the basis for the traditional DB pension, and employer pension contributions made in their behalf don’t grow in individual accounts after they leave the government.

The second set of examples features two career government employees, one assumed to retire after 30 years of service and the other after 40 years, and projects their actual DB and potential DC benefits upon retirement from state service. The analysis shows that the 30-year employee can equal or exceed the current pension benefit under a DC plan that sets aside 10 to 12 percent of annual salary, while the 40-year employee will need to have set aside more than 12 percent of salary annually to earn benefits fully equivalent to a DB pension.

In estimating the returns from defined-contribution pension funds for both sets of examples, we combined actual market returns from 1983 through 2002 with an assumed 4.6 percent real rate of return for the next 10 to 20 years. This figure is based on the cautious mid-range assumptions used by President Bush’s Commission to Strengthen Social Security, chaired by the late former Senator Daniel P. Moynihan of New York, to assess proposed private savings accounts.

It’s important to note that this estimate is below long-term historical results and lower than projected in the actuarial assumptions built into the current New York State and New York City systems.

Early-career workers

All three employees in this series of examples are assumed to have begun working for the state at age 22 in 1983, at which point they would have become members of Tier IV of the New York State & Local Retirement System.

• Employee A spent 10 years working for the state in a low-level institutional job.
• Employee B worked for 15 years in the professional, scientific and technical services unit.
• Employee C was a managerial employee for 20 years before moving to a private sector job in September 2003.
To begin with, we calculated the maximum state pension\textsuperscript{24} that would be due to each worker upon retirement at age 62 in 2023, using the current Tier IV formula combining years of service and final average salary.

We also estimated the pension savings each worker would have accumulated in a 401(k)-style fund if, during their years of state employment, they had instead belonged a defined-contribution pension plan. Savings were calculated for each worker under three different annual contribution levels—8 percent, 10 percent and 12 percent of salary. In each case, these figures are based on pay grades, contractual salary increases and incremental longevity “steps” that were effective during the time of state employment.

Investment and Return Assumptions

It is assumed in these examples that the hypothetical DC employee pension funds were not cashed in or rolled over to a new employer’s plan after each worker left the state payroll. Instead, after state employment and contributions ceased, each fund continued to passively accumulate investment gains until the date of the worker’s retirement.

Each worker is assumed to have invested in the same fund mix of 60 percent stocks and 40 percent corporate bonds between 1983 and 2002, shifting to a ratio of 50 percent stocks, 30 percent corporate bonds and 20 percent government bonds in future years.\textsuperscript{25} Performance of the funds between 1983 through 2002 was based on actual returns from stocks and bonds during that period.\textsuperscript{26}

To provide a direct comparison of state pensions and potential DC retirement benefits, each hypothetical pension fund was converted at age 62 into a “single lifetime” annuity.\textsuperscript{27}

Dramatic differences

The results of the hypothetical exercise are displayed in Figure 3. As shown, under all scenarios, the DC retirement benefit stemming from the period of state employment would dwarf the conventional DB pension.

Combining actual investment results with conservative future projections, these examples illustrate the benefits of a DC pension for younger workers who don’t spend their careers in government. Another advantage, unstated in these examples, is the flexibility and discretion these plans offer. Depending on circumstances, a worker might decide not to convert the pension fund into an annuity but make periodic lump sum withdrawals from an active investment account. Under this scenario, of course, the fund would continue to grow until it is converted into a larger future annuity, used to pre-pay an assisted living facility or nursing home, or passed on to the retiree’s heirs.

\textbf{Figure 3. Annual Retirement Benefits for Early-Career State Workers}

Comparing Current Pension Entitlements and Hypothetical Annuities at Age 62 2003 Dollars

<table>
<thead>
<tr>
<th>Tier IV State Pension</th>
<th>8% of pay</th>
<th>10% of pay</th>
<th>12% of pay</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee “A”: first 10 working years in state government, FAS of $20,603</td>
<td>$3,441</td>
<td>$10,583</td>
<td>$25,735</td>
</tr>
<tr>
<td>Employee “B”: first 15 working years in state government, FAS of $42,451</td>
<td>$12,000</td>
<td>$29,796</td>
<td>$87,500</td>
</tr>
<tr>
<td>Employee “C”: first 20 working years in state government, FAS of $64,339</td>
<td>$15,000</td>
<td>$30,780</td>
<td>$83,956</td>
</tr>
<tr>
<td>$18,000</td>
<td>$36,353</td>
<td>$45,000</td>
<td></td>
</tr>
</tbody>
</table>

\begin{itemize}
  \item[] Employee “A”: first 10 working years in state government, FAS of $20,603
  \item[] Employee “B”: first 15 working years in state government, FAS of $42,451
  \item[] Employee “C”: first 20 working years in state government, FAS of $64,339
\end{itemize}
Long-term workers

The next comparison features examples of two career state employees, both assumed to be earning $50,000 as of the end of 2002, and both assumed to have started working for the state in 1983. Employee D plans to retire in 2012, after 30 years of service, at age 55. Employee E doesn’t plan to retire until 2022, after 40 years of service.

State workers’ salaries typically grow faster than the cost of living, both as a result of promotions and of above-inflation settlements in their union contracts. Therefore, we did not simply assume level, inflation-adjusted salaries of $50,000 per employee. Instead, we constructed a salary progression to $50,000 over a 20-year period (1983-2002) that reflects average step increases and promotions consistent with the actuary’s assumptions. On the same basis, we continued to project future salaries until the projected retirement ages for Employees D and E.

The results of this analysis are presented in 2003 dollars in Figure 4.

As shown, Employee D could come close to equaling the current Tier IV defined-benefit pension if at least 10 percent of his pay was put aside in a DC account every year. He would exceed the current pension at a contribution rate of 12 percent.

Employee E is the most senior, long-term hypothetical worker in any of these examples. Not surprisingly, given the system’s pronounced bias in favor of longevity, this employee’s guaranteed pension under the current system would be larger than his annuity under a hypothetical 401(k)-style pension savings plan. But it does not necessarily follow that the DC pension is inadequate for this type of worker.

Combined with Social Security, a retirement annuity purchased with the DC savings at a 12 percent contribution rate would provide Employee E with an effective income equivalent to at least 90 percent of final average salary—a “coverage ratio” in line with what is recommended by retirement planning experts. Moreover, as an alternative to a straight single-life annuity, his pension fund can be managed in a way that does more to keep up with inflation than the partial cost-of-living adjustment that applies to the current DB pension.

Even under the very conservative future rate-of-return scenario used here, Employee E could afford to buy an annuity equaling what would be provided under the DB pension formula merely by depositing 2 percent more in his DC account (boosting the total contribution to 14 percent).

These hypothetical examples do not include late-career entrants to the public retirement system—employees who land a government job for the last 10 to 20 years of their working lives. In any investment scenario, such workers have the greatest advantage under the current pension system. They could not replicate the DB pension under a DC system unless they save much more toward their retirement.

Figure 4. Annual Retirement Benefits for Career State Workers
Comparing Current Pension Entitlements and Hypothetical Annuities at Age 62 2003 Dollars

- Employee “D”: 20 years service as of 2002, retirement in 2012, FAS=$64,123
- Employee “E”: 20 years service as of 2002, retirement in 2022, FAS=$83,772
Pension bias

As noted in this report, New York’s DB public pension plan reserves its biggest payoff for employees who spend their entire careers in government. Moreover, just as the current system discriminates against those who are on a government payroll for brief periods early in their careers, it is tilted in favor of older, late-career workers who pursue government jobs specifically to take advantage of the high pension.

Because pension benefits are financed out of a common pool, the lifetime employee’s generous pension ultimately comes at the expense of those who don’t put in 40 years on the state payroll. By the same token, the late-career worker’s windfall ultimately comes at the expense of younger, more mobile employees.

REAL PENSION REFORM FOR NEW YORK

A defined-contribution plan could be designed for New York to replace the traditional defined-benefit plans for civilian government employees.

Ideally, as in Michigan, the plan would require all new workers to enter the DC system and give all existing DB pensioners an option to switch into the system, bringing their accumulated pension assets and credits with them.

Under the New York plan proposed here, state and local government employees would be required to contribute at least 3 percent of their salaries to a retirement account. The government employer would match this threshold amount with a contribution of 5 percent, bringing the total minimum retirement savings to 8 percent of salary per year.

Employers would match up to 2 percent of additional employee contributions, so that total retirement savings of 12 percent of salary would consist of up to 7 percent from the employer and 5 percent from the employee. Workers could voluntarily contribute even more pre-tax income to their pension investment funds, subject to federal Internal Revenue Service limits but without an employer match for that extra amount.

These contribution levels would be equivalent to what is provided under the federal DC plan and the Michigan plan, and significantly larger than those provided under some major corporate plans. As in SUNY’s optional retirement program, workers would choose among several private investment fund managers, which in this case would be approved and regulated by the state comptroller. Workers could switch among investment funds during an open season in the first three months of each year. Administrative expenses would be borne by the plan’s sponsoring government agencies.

The funds in the new retirement accounts would become the immediate personal property of the worker, with the employer-financed portion vesting after one year, as in the SUNY and CUNY systems. However, withdrawals or loans from the account before retirement would be tightly restricted. Workers who left New York state employment would be permitted to roll over their retirement accounts into a subsequent employer’s DC fund, such as a 401(k), or into an Individual Retirement Account. The funds and investment returns would continue accumulate in the accounts on a tax-free basis until withdrawn at retirement.

Workers could choose to withdraw funds from their accounts without penalty at any time after they reach 59 1/2, regardless of how many years they have worked for state or local government. Retirement benefits would be higher the longer the worker waited to draw funds.

Such a reform plan would provide major advantages for both workers and taxpayers.

Advantages for Workers

• Benefits would be portable. When a worker changes jobs, her retirement account can be transferred to the new employer or converted into an IRA.
• Employer contributions, as well as any and all investment gains on those contributions, become the worker’s property after just one year’s employment.
• Workers gain a greater degree of control and discretion over their own retirement planning than is available under the DB plan.
• All employees accumulate benefits on the same basis, regardless of how long they plan to work for government.
Advantages for Employers and Taxpayers

- The recommended DC plan would effectively cap costs at 7 percent of pay, just over half the fiscal 2004-05 employer contribution for the New York State & Local Retirement System.
- Taxpayers would no longer bear the risks associated with market downturns.
- Public pension costs for the first time would become both predictable and easily understandable. The real costs of proposed benefit increases would be completely transparent, rather than obscured by complex actuarial calculations.

Under a DC system, it would no longer be possible for elected officials to significantly enhance pension benefits under the pretense that they were serving up a fiscal free lunch. This is what happened in 2000, when Governor George Pataki, then-Comptroller Carl McCall and near-unanimous majorities in both houses of the Legislature agreed to add an automatic annual COLA for all retirees and to eliminate the employee share of pension contributions for all Tier IV workers with 10 or more years of experience. At the time, proponents claimed these changes would bring no new costs, as long as the rate of return on investments remained at 8 percent. But the retirement systems proceeded to lose money over the next two years—a risk that no one involved in the 2000 changes was willing to acknowledge.

Although the stock market was invariably blamed for the subsequent increase in required employer pension contributions, Albany’s pension enhancements clearly made a bad situation much worse—accounting for fully one-half of the increase in contributions billed by the statewide system for 2003-04 fiscal years.

On the city level, pension obligations in fiscal 2004 will be $1.8 billion over the April 2000 projection. Fully $771 million of this amount could be attributed to benefit enhancements enacted at the state level or negotiated by the city with its public employee unions, according to an analysis by the Independent Budget Office.

Criticisms of DC Plans

Probably the most frequent objection to DC plans is that they shift investment risk from the employer to the worker. In a DB plan, the worker receives the specified benefits regardless of investment performance, so the worker apparently bears no investment risk. In a DC plan, the worker’s benefits depend entirely on the investment performance of his retirement account, so the worker bears full investment risk. Poor investment performance leads to lower benefits.

Concerns about investment risk understandably resonated with retirees during the stock market downturn of 2000-2002. Over the long term, however, such risks can be overstated.

As explained by a leading expert in the debate over savings-based alternatives to Social Security: “Stock market investment is indeed risky over the short term. But over the long term, stocks and bonds clearly can form the basis of stable and adequate retirement wealth accumulation for all workers [emphasis added].”

The Employee Benefit Research Institute (EBRI) has developed a model that projects the proportion of an individual’s pre-retirement income that might be replaced by 401(k) plan accumulations, under several different projected scenarios. Based on equity returns from 1926 to 2001, the model finds that a combination of 401(k) benefits and Social Security payments will produce benefits ranging from 103 percent of projected pre-retirement income in the lowest income quartile to 85 percent in the highest quartile.

Significantly, the EBRI reported, “[e]ven if equity returns in the future are projected to replicate the worst 50-year segment in the Standard & Poor’s (S&P) 500 history (1929 to 1978), 401(k) accumulations are still projected to replace significant proportions of projected pre-retirement income.”

Moreover, proponents of traditional plans tend to downplay the potentially devastating effects of high inflation on a defined-benefit pension. Adjusting benefits for inflation—even on a partial, limited basis, as was just done in New York—is enough to make an already costly DB plan prohibitively expensive for taxpayers.

Under a DC plan, asset value tends to rise along with inflation over the long run, providing something closer to a real market rate of return. This would tend to keep prospective long run benefits rising with inflation.
Over a long-term horizon, workers can weather many ups and downs in investment performance. Those nearing retirement, when savings become more vulnerable to market downturns, can minimize risk by changing the mix of their investments to include more bonds than stocks, and by avoiding too big an equity stake in any one industry or company.

Special Issues

As noted, New York police and firefighters are eligible for retirement at half pay after just 20 years on the job. All state correction officers, along with many local jail guards and sheriff’s deputies, can retire at half pay after 25 years. Thus, while the pension for most workers is designed to reward longevity, public safety employees have an incentive to retire as early as possible.

There’s a lot to be said for the argument that chasing bank robbers, fighting fires and guarding hardened criminals is a young person’s job. But so is heavy construction and road-building work—yet even unionized workers in these fields generally lack the kind of early retirement pension benefit available to police and firefighters.

Nonetheless, early retirement at half pay has come to be viewed as an integral part of the overall police and fire compensation package. In reshaping the pension system to make it more affordable, careful cost benefit analysis needs to be devoted to the relationship of retirement benefits to salaries and work rules, and to the question of whether the minimum service period can reasonably be extended—to, say, the same 25 years as state corrections officers and county sheriff’s deputies. Any DC plan designed to preserve an early retirement preference for such workers would require higher payroll contributions than the range described above for other employees. Moreover, since withdrawals from conventional retirement savings plans are subject to a federal tax penalty before age 59 1/2, some combination of DB and DC plans will be needed in order to continue allowing early retirement.

Fairness

New York’s public pension system is a vestige of the last century, when ultra-secure retirement benefits and civil service job protections were seen as compensation for the low wages paid to a non-unionized government workforce.

Nowadays, public employee unions are the most powerful interest groups New York State. As more than one labor leader has been known to observe, union members effectively elect their own bosses in the State Capitol and City Hall. Elected officials have rewarded unions’ campaign support by preserving the traditional pension system and other benefit perks—all the while agreeing to contracts that raise employee wages faster than inflation without regard for performance or productivity (which, in most cases, is not even measured).

Career government workers have an obvious interest in preserving a pension guarantee specifically to reward longevity while shielding them from any investment risk. Since the most senior employees also tend to wield the most clout within the unions, this explains why union leaders can be expected to continue supporting a system that actually shortchanges at least a sizeable minority of their members.

But while this provides the political explanation for the persistence of DB pensions in the public sector, it hardly serves as a justification for continuing the system, especially when the fiscal hazards of maintaining it have been so vividly highlighted by the latest funding crunch.

Costly return to the “norm”

“The boom of the 1990s was an exceptional time that allowed (employer pension) contributions to drop to zero in some years,” State Comptroller Alan Hevesi has pointed out. “But it is unrealistic to expect to provide a pension without any cost.”

Government employers in New York, Hevesi says, “must plan to again make contributions of at least 12 to 16 percent of payroll as a normal pension cost.”

In the face of this trend, individual retirement savings accounts represent a fair, sensible alternative to outmoded public employee pension plans whose “normal” costs would place an intolerable burden on taxpayers for decades to come.
APPENDIX A: NEW YORK’S PUBLIC PENSION SYSTEMS

Here is a list of the public pension systems in New York State and a description of their primary membership:

**New York State & Local Employees Retirement System**
All employees—in occupations other than police officers, firefighters and educators—on the payrolls of the state and of local governments outside New York City

**New York State & Local Police and Fire Retirement System**
Police officers and firefighters employed by the state and by local governments outside New York City

**New York State Teachers Retirement System (TRS)**
Teachers and other education professionals employed by school districts outside New York City

**New York City Employees Retirement System**
City employees other than those employed by the police, fire and education departments

**New York City Teachers’ Retirement System**
Education professionals employed in the city’s public schools

**New York City Board of Education Retirement System**
Civil service workers and other non-education professionals in the city education department

**New York City Police Department Pension Fund**
City police officers

**New York City Police Department Pension Fund**
City firefighters

APPENDIX B: HOW GENEROUS ARE NEW YORK’S PUBLIC PENSIONS?

New York’s benefit levels and eligibility guidelines are not atypical for the public sector. Some states offer earlier retirement ages or larger benefits than New York for some occupations—but such largess is often accompanied by the requirement that employers and employees contribute much more to their retirement systems.

Two recent nationwide reviews of public retirement systems showed that New York’s employee share of pension contributions is relatively low compared to requirements in most jurisdictions:

- Of the 85 state and local government retirement systems included in a nationwide survey conducted for the Wisconsin Legislature in 2000, only 18 had mandatory employee contribution rates lower than the maximum 3 percent required of most New York public employees during their first 10 years on the job. Only 11 pension plans required no contribution from some or all employees, as is now the case in New York.

- Only four of the 34 states with pension systems most comparable to that of New York required no pension contribution from employees as of 1999, according to the U.S. General Accounting Office. Among states in this group requiring a member contribution, only five were below the current New York maximum of 3 percent.
Private counterparts

As noted on pages 5–6 of the main report, few private employers offer any guaranteed pension. In fact, even among the shrinking number of companies offering defined-benefit pensions, few rival the package available to career public employees in New York.

• General Electric, for example, offers workers a DB pension roughly half the size of the New York government plan, combined with a defined-contribution savings account. IBM also offers a package of DB and DC retirement benefits, although it is in the process of converting its traditional DB plan into a cash balance plan.

• Members of the United Auto Workers are famous for their high hourly earnings and big pensions—but after age 62, their retirement benefits are reduced by the amount of Social Security they receive. New York government retirees, by contrast, are entitled to full Social Security benefits in addition to their full pensions.

• Microsoft, the quintessential high-tech growth company, offers no DB pension at all—just a 401(k) plan, plus the option to purchase company stock at 85 percent of market value. 44

Other comparisons

Because there are literally tens of thousands of different privately administered pension plans offering seemingly endless permutations of benefits and eligibility standards, it is difficult to conjure an “average” private plan for comparison with public pensions. In the absence of such data, one measure of how New York’s DB pension compares to private plans is a 1999 Congressional Budget Office (CBO) report focusing on the federal government’s pension plans for civilian employees.

Even among a select group of larger employers offering more generous retirement benefits, including guaranteed pensions, the CBO said only 15 percent allowed retirement with a full pension at age 55 after 30 years of service, which is permitted in Tier III and IV of the New York system. 45 In this same group, less than one private employer in ten provided for any kind of regular post-retirement inflation increase, such as the one extended to New York public employees in 2000.

Consistent with the CBO analysis, Census Bureau data indicate the average state and local government retirement payment in New York as of 2002 was $20,057 per person, compared to an average company or union pension of $11,949. 46
ENDNOTES

1. High public pension costs also contributed to the New York fiscal crisis of the mid-1970s, prompting legislative efforts to rein in pension benefits in 1976 and 1983, as reviewed on pages 4–5.

2. “Local governments must plan again to make contributions of at least 12 to 16 percent of payroll as a normal pension cost,” Comptroller Alan G. Hevesi said on Sept. 8, 2003.

3. The precise costs would depend on the level employees choose to contribute, since the employer contribution would be made on a matching basis. See pages 10–11 for details.

4. The projected employer pension contribution for New York City and New York State and local government workers other than police and firefighters is at least 12 percent of salary for fiscal years beginning in 2004.

5. This is based on the state actuary’s expectation that approximately 50 percent of newly hired retirement system members terminate employment within 10 years.

6. The average length of service for members of the New York State and Local Employee Retirement System is 24 years, according to the state actuary.

7. The $100 billion, 944,500-participant New York State and Local Retirement System alone is the second largest in the country, after California’s massive “CalPERS” system.

8. Most New York State government employees also qualify for subsidized post-retirement health insurance. However, retiree health benefits are treated as a current expense; they are not financed out of the pension fund but out of the “general state charges” line in the budget’s general fund. While subject to collective bargaining, they are not part of the pension system or the constitutional pension guarantee.

9. Article 5, Section 7 of the Constitution mandates that “membership in a retirement system shall be in the nature of a contract, the benefits of which shall not be diminished or impaired.” New York is one of only five states to provide this maximum level of security for government pensions.

10. For most current government workers, final average salary (FAS) is the average of wages earned during any 36 consecutive months when earnings were the highest, subject to certain limitations. For members of Tiers II, III and IV, the wages in any year used in the FAS calculation cannot exceed the average wage of the previous two years by more than 10 percent.

11. On average, Social Security benefits are 40 percent of average annual earnings over a worker’s entire career.

12. For example, a 40-year state employee retiring at 62 with an FAS of $50,000 (roughly the average for all state workers as of 2002) immediately qualifies for a state pension of $37,500 and Social Security benefits of $12,948, yielding a total of $50,448. Since the pension payment is not subject to federal payroll tax or to state and local income taxes, which can approach 10 percent, the effective difference between retirement and working incomes is even larger than it appears in this example.

13. The average age at retirement in the New York Police Department in recent years has been 43. New York City police pensions date back to the 1850s and were the first of their kind in the United States. Retirement at half pay first became an option in 1878.

14. In 2002, newly retired members of the state’s police and fire system received an average pension of $48,456 a year, according to the system’s annual report.


16. Unions campaigned against the switch, and the time window was limited. With a wider window and a marketing campaign that did a better job of informing workers, more might have switched.

17. In addition to the state, four large Michigan counties and the capital city, Lansing, have moved from DB to DC pensions plans.

19. In making the move, state retirement officials expressed concern that 90 percent of investments were directed to only three of 11 available funds, principally a conservative “default” option. These statistics did, indeed, highlight a known weakness in the DC system. Left entirely to their own devices, many participants in such plans tend to overly cautious in their investment decisions, as reflected in sub-market rates of return for 401(k) accounts in recent years. However, rather than reforming the manner in which funds are invested under the existing DC plan, Nebraska officials appear to have been distracted by goals of “competitiveness” with public DB systems and by a consultant’s recommendation to the effect that only a pension duplicating the worker’s pre-retirement standard of living could be called “adequate.”

Under the new plan, the employer will guarantee employee account balances and annuities at retirement. Responsibility for investment decisions (and all the downside risk) is shifted under the cash balance plan to a state-run Investment Council.

20. Guaranteed pension benefits for post-1984 Federal Employee Retirement System members accrue at the rate of 1 percent of salary per year—only half the level available to New York State employees.


22. It’s assumed the employee’s first 10 years were in Pay Grade 14 and the last five were in Pay Grade 18.

23. It’s assumed this employee progressed from Grade 14 to Grade 18 after 10 years, and then to Grade 23 after 15 years.

24. This would be “Option 0,” the single life allowance, which does not provide for payments to a beneficiary after the retiree’s death.

25. This is consistent with the recommendation by most financial planners that workers adopt a more conservative investment mix, with fewer stocks and more bonds, as they approach retirement.

26. The return on each worker’s corporate bond portfolio was equal to the average return on all corporate bonds rated in this period by Moody’s Investor Service. The return on each worker’s stock portfolio matched the composite returns on the S&P 500 as reported by Ibbotson Associates in its 2003 Stocks, Bonds, Bills and Inflation Yearbook. This index reflects the returns on “large cap” corporate stock and this is a relatively conservative number; the historical composite returns on “small cap” tend to be higher.

27. Annuities were calculated by entering accumulated savings as “deposits” on the webannuities.com site, which generates an average annuity estimate from 16 companies.

28. The state actuary assumes underlying annual inflation and wage growth averaging 5.8 percent.

29. The IRS limit on pre-tax employee contributions to 401(k) accounts is $12,000 as of 2003. Contributions above that amount are taxable.

30. For example, the Microsoft and IBM pension savings plans match only 3 percent of employee pay contributed to 401(k) savings plans, while General Electric matches up to 3.5 percent of pay.

31. As in all DC plans, the employee’s portion of the account, including all investment gains, immediately is considered the employee’s property.

32. This is the minimum age at which the IRS allows penalty-free withdrawals from qualified retirement savings plans.

33. Under the current system, Tier IV workers with less than 10 years of service can withdraw only their own contributions, with interest of just 5 percent. After 10 years, there is no right of withdrawal.


37. Sarah Holden and Jack VanDerhei, “Can 401(k) Accumulations Generate Significant Income for Future Employee Benefits,” Employment Benefit Research Institute Issue Brief, November 2002. The EBRI model is based on an average contribution of 9.3 percent of pay, which is less than the maximum recommended for New York. It also assumes levels of funding withdrawals that would be restricted or prohibited altogether for participants in the proposed New York plan.
38. EBRI’s 401(k) model (Ibid.) found that a three-year bear market immediately before retirement could depress the level of pre-retirement income replacement by 13 to 17 percent. By comparison, inflation between 1978 and 1981 eroded the value of a dollar by 25 percent.

39. The distribution of worker longevity on state government payrolls can be viewed as a pyramid, with most workers clustered near the base, in bands with least experience. In 2001-02, from 40 to 44 percent of the general employees (excluding police and firefighters) in New York City and in others towns, cities and counties had spent less than 10 years in the public pension system; more than 80 percent had less than 20. The state government’s workforce is older and more senior on average; at the state level, about 33 percent of employees had been in the pension system less than 10 years, and 68 percent had been in the system for less than 20 years.


41. Ibid.


44. Other large companies including GE and IBM offer similar stock purchase options.


46. Weighted survey data from the March 2002 supplement to the Current Population Survey. These averages compared only public and private DB plans and did not include income from 401(k) accounts, Individual Retirement Accounts and other savings-based retirement plans commonly found in the private sector.
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