NATIONAL INSTITUTE ON
Retirement Security
Reliable Research. Sensible Solutions.

Strong Public Pensions for Today and Tomorrow

Just the Facts

State and local pension plans in the United States are an economic force. These plans hold $2.6 trillion in assets and serve 14.4 million active employees. They pay out some $162.7 billion in pension benefits each year to some 7.5 million retirees.

The data in this fact sheet were taken from a larger "Public Pension Resource Guide." This guide was developed to provide readers with facts and data on the important role that public pensions play in our economy—for employee and retirees, public employers, and taxpayers alike.

"Public Pension Basics" presents key facts about how pensions work—how benefits are earned, how pensions are funded, and how investment decisions are made. It also provides data on the number of Americans who rely on pensions for their retirement security.

"Why Pensions Matter" discusses the characteristics of pension plans that make them attractive to employees, employers, taxpayers, and the broader economy.

"Strong Public Pensions for Today and Tomorrow" identifies practices that can enhance the long-term sustainability of public pension plans, specifically through the integration of funding, investment, and benefit policies.

The full guide is available at **www.nirsonline.org**.

All public pension plan stakeholders—employees, employers, and taxpayers—share a common interest in seeing that public pensions are adequately funded and prudently financed over the long haul.

For plans to serve the long-term interests of all stakeholders well, each aspect of DB pension plan management—the funding policy that describes how contributions to the plan will be made, the investment policy that dictates how contributions are invested, and the benefit policy that governs how employees earn benefits in the plan—should be tightly linked to the other.

A Disciplined Funding Policy is Important to Long-Term Financial Health

In order to ensure that the plan will be able to meet its financial commitments, a funding program should aim to achieve full funding—or a funded ratio of 100 percent—over a reasonable period of time.

Funding the ARC

A critical measure for any funding effort is the "annual required contribution" (ARC), which includes the "normal cost" of the plan (the cost of benefits currently being earned this year), and also may include another amount to pay for a portion of benefits earned in past years that have not yet been funded.

If the plan receives contributions equal to the full ARC each year, it will make progress toward full-funding. If contributions are insufficient to cover the full amount of the ARC, the unfunded liability of the plan is likely to grow. Failure to pay the ARC only shifts costs into the future.

However, enforcing a funding policy is not always completely within the power of a retirement system. Government finance experts recommend that when contributions fall short of the ARC, the board of trustees should prepare a report that analyzes the effect underfunding has on the system, to be shared with all stakeholders.

Affordability and Shared Responsibility for Funding

In the public sector, it is common for both employers and employees to make contributions to their pension programs. This shared responsibility model spreads the financial burden of providing benefits, and thus contributes to long-term pension sustainability.

This approach can be contrasted with the situation in the private sector, where DB plans rely virtually exclusively on employer contributions. Significant employee contributions may be one factor adding to the resilience of DB pensions in the public sector, where they continue to be the dominant type of retirement plan, as compared with the trend in the private sector, where DB coverage has been gradually declining over the past three decades.

The Interdependence of Pension Plan Benefit, Funding, and Investment Policies

Funding and Investment Policies Can Support Predictability and Intergenerational Equity

DB pension plans in state and local government are pre-funded. Pension contributions from employers and employees are invested, and the corresponding investment earnings help to finance the benefits that will ultimately be paid. Between 1993 and 2006, nearly 70% of pension system revenues came from investment earnings, not contributions.

Predictable Contributions

One challenge to predictable, stable contribution rates is the cyclical nature of investment returns. Contribution burdens can be quite low when the economy is at a cyclical peak, and burdens can grow at the economy's nadir—in this way, the burden of contributions can be counter-cyclical.

The actuarial practice of "smoothing" asset values and amortizing investment gains and losses over a period of time can help to reduce volatility in contribution rates and ameliorate counter-cyclical funding burdens. Smoothing is consistent with long-run sustainability only if there is the discipline during both good and bad years to stick to the funding plan.

Another approach to encouraging predictable contribution rates over time, which are fair to each generation, is to set a floor below which contributions may not fall, even when the plan is very well funded. For instance, employers may be required to fund at least the "normal cost" of the plan each year—that is the cost of benefits that are accruing in the current year—regardless of how well-funded the plan may be.

Intergenerational Equity

The principles of accrual accounting require that the cost of public services be recognized in the period when they are delivered. This approach promotes equity across generations, since it means that those who enjoy public services at one point in time pay the costs associated with providing those services.

A critical method of maintaining roughly level contributions is the use of long-term projected rates of return in calculating pension costs. Because investment returns in any given year are inherently uncertain, when determining contribution rates, actuaries apply their best estimate of long-term expected returns, based on a plan's underlying portfolio.

Public pension plans, like private pensions and other institutional investors, tend to hold a diversified portfolio of assets. The median expected rate of return for state and local pension plans is 8%, while private pension plan sponsors expect to earn a slightly higher rate of return of 8.25%.

Accurately assessing expected returns is important, because if contribution rates are based on an interest rate that is either above or below the rate that is most likely to be earned on investments, in the future there is likely to be a mismatch between the size of the plan's assets and the size of a plan's obligations.

Key Considerations in Benefit Policy

Recruitment and Retention
Public employers are interested in designing a benefit policy that supports the recruitment, retention, and retirement goals for their workforces. Because of their deferred nature, retirement benefits can have the effect of encouraging employee commitment to the employer.

Employers may find that periodically updating benefit design is consistent with achieving their human resource management objectives and/or budgetary constraints. But for such changes to be consistent with the long-term health of the pension system, the cost (or savings) associated with such changes must be integrated with the plan's funding policy. Government finance experts recommend that all benefit enhancements be actuarially valued before they are adopted in order to ensure that stakeholders have a complete understanding of their long-term financial impacts.

With the recent stock market decline, a number of states and localities have begun to consider benefit changes such as requiring longer service for retirement eligibility, higher retirement ages, and limits on cost of living adjustments as a way to control long-term pension costs.

Public employers across the board are electing to make modifications within the existing DB plan structure, as opposed to making a wholesale change to another type of plan, like a defined contribution plan. This pattern speaks to the flexibility of the DB model in accommodating changing conditions.

Benefit Adequacy
Ensuring that retirees will be able to achieve an adequate income in retirement is an important concern. An adequate retirement income is often defined as one that will allow a retired household to enjoy roughly the same standard of living as it did before retirement.

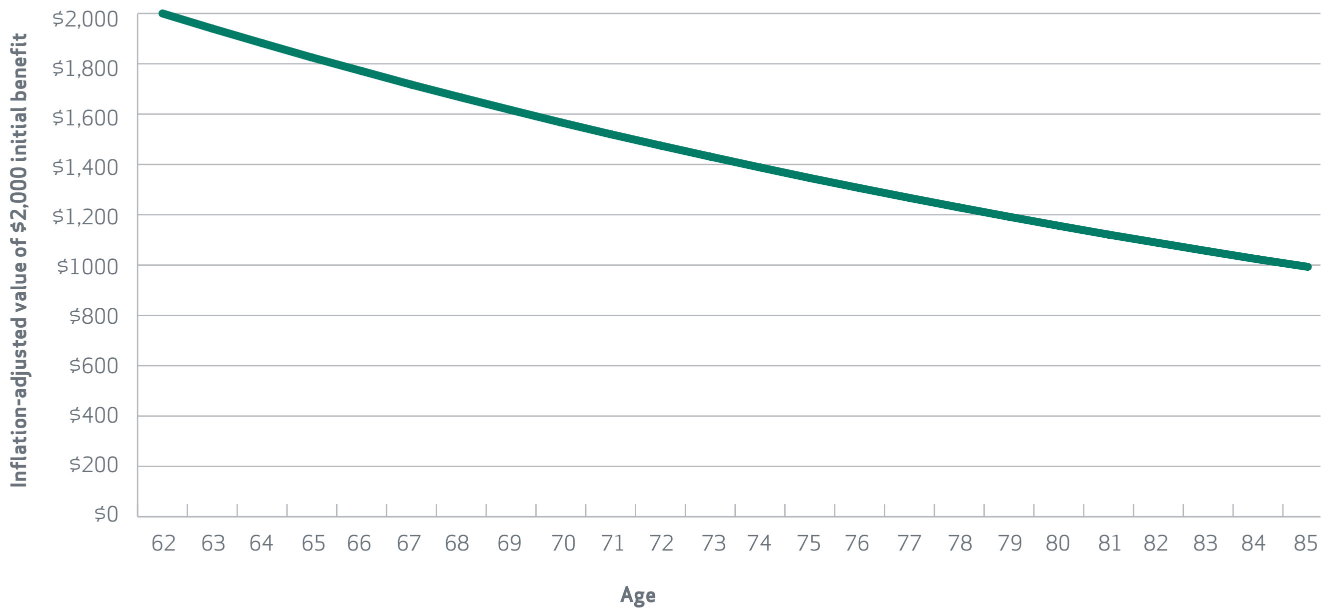
A replacement ratio (or replacement rate) compares a household's post-retirement income from all sources to its income before retirement. Research has found that a replacement ratio of anywhere from 65% to 85% of pre-retirement income might be considered adequate. However, other researchers believe that a replacement ratio in excess of 100% might be necessary.

Most public pensions provide benefits that—in combination with Social Security and personal savings—meet generally-accepted standards of benefit adequacy for a career employee.

A retirement benefit that may appear adequate at retirement can become inadequate over time, if its value erodes due to rising prices, or inflation. Because of this, many public retirement systems offer cost-of-living-adjustments (COLAs).

While COLAs provide important protections for retirees, they do cost money. One concern about COLAs that has arisen recently is the extent to which these are fully accounted for and pre-funded among state and local retirement systems. Delaying the funding of promised benefits only increases costs in the future.

The Effect of 3% Inflation on a $2,000 Initial Benefit



Transparency and Fairness

Americans overwhelmingly agree that all workers, including those in public service, should have access to a pension plan so they can be independent and self-reliant in retirement. At the same time, taxpayers may reasonably want to seek assurances that pension benefits are not "overly generous." To address this concern, pension systems in about 25 states place some type of cap on the pension benefit that can be paid.

The problem of "pension spiking"—where an employee is able to inflate his pension benefit by steeply increasing his pay at the end of his career—has drawn increased attention in some areas of the country. Spiking is considered abusive because when pay escalates rapidly at the end of the career, the pension benefit is unexpectedly increased, and the contributions that had been made to cover that benefit may prove insufficient. Many states have tightened loopholes and implemented anti-spiking measures to address these issues.

Regardless of the specific benefit design, any pension plan must be able to ensure that it will have the funds to pay promised benefits when they are due. Contributions that come into the plan, when added to the investment earnings on these contributions over time, must be sufficient for the plan to pay all benefits that have been earned.

Common sense funding, investment, and benefit policies that work in a coordinated fashion will support the long-term sustainability of public pensions and will continue to serve the needs of employers, employees, and taxpayers for many years to come.