Public Pension Basics

Just the Facts

A traditional pension plan, also called a defined benefit (DB) pension plan, is a pooled retirement plan that offers a predictable defined monthly benefit in retirement. A DB pension provides retired workers with a steady income stream that is guaranteed for the remainder of the retiree's life.

How Are Benefits Earned?

Coverage in DB pension plans is universal—eligible employees are automatically enrolled in the pension plan.

The amount of monthly income each employee receives is ordinarily a function of the years of service with the employer, the worker's pay at the end of his/her career, and a fixed multiplier that is determined by the plan. This is called a "final average pay" design.

What Do These Benefits Mean for Employees?

Social Security and DB pension income remain the largest and most significant sources of retirement income for the current elderly population. Among all Americans aged 65 and older, DB pensions make up 17.7% of their current income, and Social Security makes up 36.7%.

Especially for middle-income retirees, DB pension income remains an extremely significant source of retirement income. Retirees in the third and fourth income quintiles rely on DB pensions to provide 15.7% and 24.0% of their total retirement income, respectively.

For middle and higher income earners, then, the combination of a DB plan, Social Security, and supplemental savings—the so-called "three-legged stool"—still offers the best opportunity to maintain a middle class standard of living in retirement.

It is important to note that as many as 30% of all state and local workers are not covered by Social Security system. For those public employees not covered by Social Security, the DB pension is all the more important, as it is the only source of steady, monthly income that these workers will receive in retirement.

## How Are Pensions Funded?

Pension plans are pre-funded, which means that regular contributions for each worker are made into a retirement fund during the course of that worker's career. State and local DB pension plans are usually funded by employer contributions and contributions from employees themselves, while private sector pension plans are almost always funded solely by employer contributions.

All DB pensions have the advantage that investment earnings can do much of the work of paying for benefits, because the contributions made on behalf of current workers are invested and these investment earnings compound over time.

Earnings on investments have historically made up the bulk of public pension fund receipts. Between 1993 and 2007, 10.3% of total state and local pension fund receipts came from employee contributions, 19.4% from employer contributions, and 70.4% from investment earnings.

Aggregate State and Local Pension Contributions by Source, 1993-2007

Employee Contributions **10.3%**

Employer Contributions **19.4%**

Investment Earnings **70.4%**
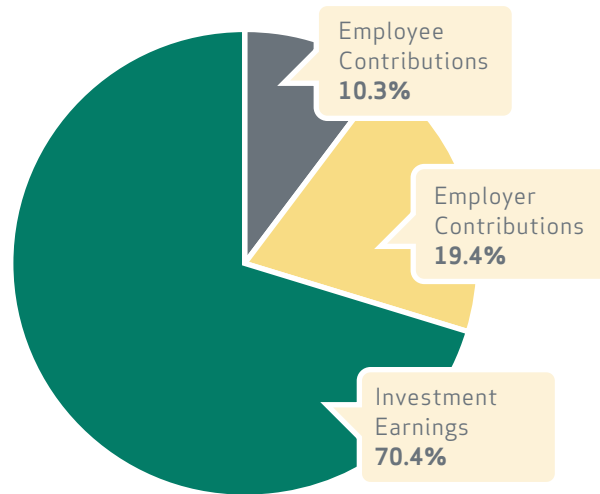
How Are Contribution Rates Determined?

The amount needed to contribute each year can be determined through an actuarial analysis. The plan actuary determines the cost associated with new benefits earned in that year (normal cost) plus any additional amount that might be required to make up for shortfalls that have developed in the past.

It is important that the actuarially required contribution (ARC) be contributed to the pension trust each year. Public pension plans as a group have been diligent about pre-funding, especially in recent years.

How Are Investment Decisions Made?

DB pension plans are overseen by trustees who have a fiduciary duty to ensure that the retirement fund is operating in the best interest of workers and retirees. These trustees hire professional asset managers to steer the investment of these funds.

Both public and private sector pension plans maintain a balanced portfolio of equities, bonds, alternative investments, and cash. In doing so, plans follow the general tenets of modern portfolio theory, which holds that an investor can reduce risk and enhance return by diversifying assets across the entire portfolio. Public pension plans tend to invest in a similar mix of assets, as compared with plans in the private sector.

A plan's asset allocation at any one time is not permanent—plans regularly review their portfolio mix, and make revisions when appropriate. A recent study has found that DB pension plans tend to invest pragmatically, looking to the long-term and engaging in prudent investment practices.