NRTA PENSION EDUCATION TOOLKIT

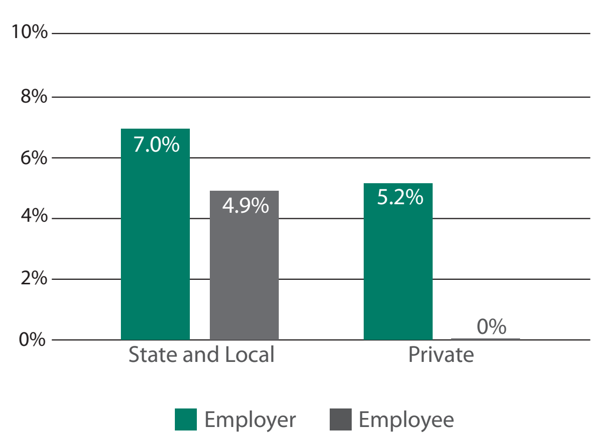
Pension Contribution Requirements

With the economic downturn that began in 2008, many states and municipalities have faced difficult budget gaps. At the same time, pension funds—like all investors—felt the pain of stock market losses. As governments face the challenge of balancing their budgets, while at the same time meeting their pension obligations, you may wonder what may be happening to your pension plan.

Understanding How Pensions are 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. In most state and local pension plans, these contributions come from both employers (the city or state) and employees, who contribute to the pension directly out of their own paycheck each month.[1] This differs from the situation in the private sector, where pensions are employer-funded.

Figure 1. **Employer and Employee Contributions as a Percentage of Payroll, by Sector**[2]



In thinking about pension contribution requirements, remember that…

- Pension plans are "pre-funded," which means that regular contributions for employees are made into a retirement fund during their careers.
- In most state and local pension plans, unlike the private sector, employees contribute to their pension directly out of their own paycheck.
- Investment returns make up the bulk of pension fund receipts. A full 63 percent of pension fund receipts are made up of earnings on pension investments.
- Keeping the pension plan well-funded is typically a shared responsibility between employees and employers.
- Some governmental employers have failed to contribute the full amount of money to the pension fund that they should. When pension contributions are pushed into the future, this increases the cost in later years.
- Because of the stock market downturn, pension contributions have gone up. The good news is that these additional contributions—coupled with significant pension reforms that states have made—should fully offset the effects of the economic downturn over time.that states have made—should fully offset the effects of the economic downturn over time

NRTA
AARP's Educator Community

NATIONAL INSTITUTE ON
Retirement Security
Reliable Research. Sensible Solutions.

On average, public sector employees contribute about 5% of each paycheck to their pension. Employers contribute 7%. In the private sector, employers contribute 5.2% and employees do not contribute.

All pre-funded group pension plans have the advantage that investment earnings can do much of the work of paying for benefits over time. This is because the contributions that are made for current workers are pooled together, and invested in a diversified mix of assets—stocks, bonds, real estate, government securities, etc. These investment earnings compound over time.

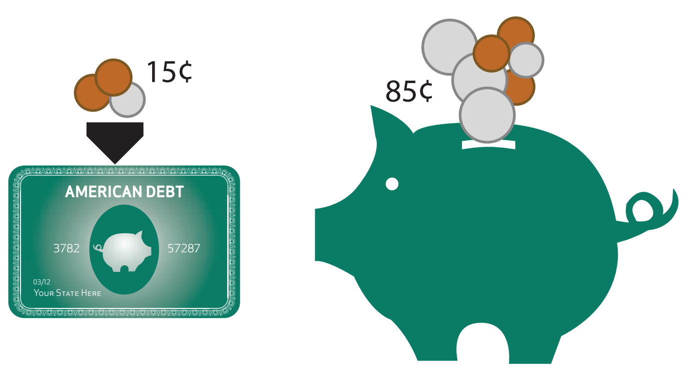
Historically, earnings on investments have made up the bulk of public pension receipts. Between 1993 and 2011, about 63% of receipts came from investment earnings alone. Another 12% came from employee contributions, and about 25% came from employer contributions.[3]

Another way of saying this is that employers contribute just about 25 cents of every dollar of total pension fund receipts. Employees contribute another 12 cents, and the rest—a full 63 cents on the dollar—is made up of investment earnings.

The Importance of Making Contributions on Time and In Full

Normal Cost + **Payments on any Unfunded Liability** = **ARC**

In order to figure out how much the employer needs to contribute to the pension fund each year, the plan hires actuaries, who make calculations and determine what the city or state should put in. These actuaries calculate the cost associated with new benefits earned in that year (also called the "normal cost") plus any additional amount that might be required to make up for shortfalls that have developed in the past.[4] Together, these amounts are referred to as the annual required contribution, or "ARC."



It is important that the full amount of the ARC be contributed to the pension trust each year. If a state or city fails to make contributions on time and in full, pension costs will almost assuredly increase in later years.[5] When states contribute less than 100% of their ARC, it is similar to putting the pension obligations on a credit card. They are accruing debt, and the more the balance accrues, the more that must be paid later on.

As a group, public pension plans have been diligent about funding their pensions, especially in recent years. On average, nearly 90% of the ARC was received by the largest state and local retirement systems in the country. Most funds (more than 6 in 10) received payment for the full amount of their ARC or something close to it in 2012, even as contribution requirements have increased.[6]

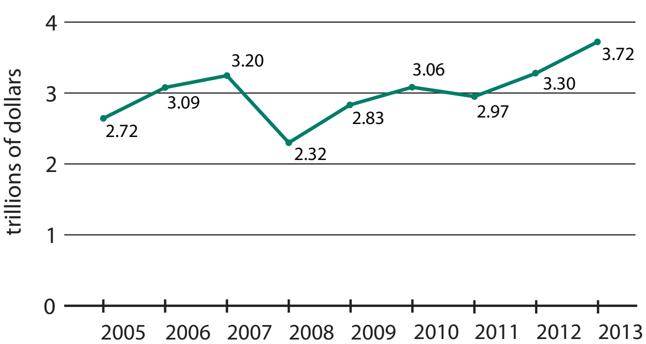
Unfortunately, in the past several years, other states and cities have failed to keep up with their required pension contributions, and are now finding that the consequences of that delay are catching up to them in the form of much higher required pension contributions. In other words, their accrued credit card debt needs to be paid off.

The Economic Downturn Has Caused Contributions to Increase in Many States

Today, even states that have done a good job of keeping up with their pension contributions in the past are facing growing contribution requirements. The economic downturn brought about unprecedented losses in the stock market. Because part of public pension funds are invested in stocks, these plans—like all investors—experienced substantial investment losses.

As the stock market dropped and the economy slid into recession, the market value of public pension holdings fell from $3.2 trillion at the end of 2007 to $2.3 trillion at the end of 2008. As the markets have rebounded, public pensions have benefited. By June 2013, the value of public pension assets had recovered to about $3 trillion[7]—but those gains have not fully made up for the huge prior losses.

Figure 2. **Value of Public Pension Holdings**



Clearly, state and local pension funds took a big hit. And as a result, most funds have required additional contributions to fill the gap.

The good news is that because most states had been paying what they owed each year before the downturn, the increase in cost is manageable for most states. Meanwhile, state and local governments across the country have been making adjustments to their pension systems to ensure that they will be on a strong footing for the long-term. The actions taken by states to date have been quite substantive and varied, including increased employee contributions and lower benefit levels. Boston College finds that for most states, the reforms already implemented should fully offset the effects of the economic downturn, ensuring the plans' long term sustainability.[8]

Unfortunately, the minority of states that had been less disciplined about making contributions before the crisis hit are now experiencing a "double whammy"—they must make up for contributions that were missed in the past *and* also make additional contributions to compensate for stock market losses. It's important to note that this situation may have been avoidable, had the state or city done a better job with making contributions on time and in full.

Pensions Squeeze More Value out of Each Contribution Dollar

Regardless of whether states and cities have been responsible about making their scheduled pension contributions in the past, looking forward, it's important to recognize the benefits that traditional group pension plans provide—not just to employees and retirees, but also to taxpayers.

Group pension plans squeeze more value out of each dollar of contributions—whether they come from employees or taxpayers—as compared with retirement plans made up of individual accounts (so-called "defined contribution plans" plans). Because group pension plans pool their assets and are professionally managed, they are able to achieve better investment returns. Better investment returns can mean that fewer contributions are necessary. Research has found that a group pension can achieve a target retirement benefit at about half the cost of individual, defined contribution accounts.[9]

This means that especially in tough economic times like these, public pension plans make sense. They remain a highly cost-effective way to provide for the retirement security of public sector employees. That makes traditional pensions a good deal for employees, retirees, *and* taxpayers.

---

1 Munnell, A.H., Haverstick, K., and Soto, M. 2007. *Why Have Defined Benefit Plans Survived in the Public Sector?* Chestnut Hill, MA: Center for Retirement Research at Boston College.

2 Munnell, A.H., J.P. Aubry, J. Hurwitz, and L. Quimby. 2011. *Comparing Compensation: State-Local Versus Private Sector Workers.* Chestnut Hill, MA: Center for Retirement Research at Boston College.

3 U.S. Census Bureau. 2013. *State and Local Government Employee-Retirement Systems*. Washington, DC: U.S. Census Bureau.

4 Peng, J. 2009. *State and Local Pension Fund Management*. Boca Raton, FL: CRC Press, Taylor & Francis Group.

5 Logue, D.E., and Rader, J.S. 1998. *Managing Pension Plans: A Comprehensive Guide to Improving Plan Performance.* Boston: Harvard Business School Press.

6 Brainard, K. 2013. *Public Fund Survey Summary of Findings for 2012*. National Association of State Retirement Administrators.

7 Lambert, L. 2013. U.S. public pension investments jump, costs surge too. *Reuters*, September 23.

8 Munnell, A.H., J.P. Aubrey, A. Belbase, and J. Hurwitz. 2013. *State and Local Pension Costs: Pre-Crisis, Post-Crisis, and Post-Reform*. Chestnut Hill, MA: Center for Retirement Research at Boston College.

9 Almeida, B., and Fornia, W. 2008. *A Better Bang for the Buck: The Economic Efficiencies of DB Plans*. Washington, DC: National Institute on Retirement Security.