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.

This “Public Pension Resource 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.
What Is a Pension?
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. With a modest DB pension, Social Security, and supplemental individual savings, a retiree can have a good chance at a secure retirement.

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. Earnings on investments have historically made up the bulk of pension fund receipts for plans in both the public and private sectors.

The amount that must be contributed to the pension fund each year is determined through an actuarial analysis. It is important that the actuarially required contribution (ARC) be contributed to the pension trust each year.

DB pension plan trustees have a fiduciary duty to participants in the plan. They hire professional asset managers to help steer the investment of pension funds. Both public and private sector pension plans maintain a balanced portfolio of equities, bonds, alternative investments, and cash.

Who Has a Pension?
Of the 31.6 million older American households in 2006, about half had income from a DB pension. About 29.7% of all older households in 2006 had pension income from a private sector job, 12.3% had pension income from a public sector job, and 5.4% had both public and private DB pension income. Among current U.S. workers, 21 million private-sector American workers had a workplace DB pension plan in 2007, while 14.2 million state and local workers had access to a DB pension plan.

Why Pensions Matter to Employees: They Offer the Best Chance for Retirement Security

DB pension plans are very effective at supporting retirement security for the middle class, for several reasons. DB pensions provide lifetime, broad-based, and secure sources of retirement income. DB pension plans usually also provide spousal protections and disability benefits.

Although pension income goes a long way in ensuring Americans’ middle-class status in retirement, it tends to be relatively modest. Among Americans aged 60 and older, in 2006 the average pension benefit was $15,784 per year, and the median benefit was $11,467 per year.

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.

Americans with DB pension income are much more likely to achieve financial security in retirement than those without such pensions. Among early Baby Boomers (born 1946-1954), 49% of those with DC plans, and 50% of those with no retirement plan are at risk of being unable to maintain their pre-retirement standard of living after they stop working. Among households with DB pensions, these numbers drop significantly—to 15% for those with just a DB pension, and 12% for those with both DB and DC income.

Additionally, DB pension plans seem to play a unique role in shrinking gender and racial/ethnic income gaps in retirement. The percentage of American households classified as poor and near poor drops across gender and race categories when older Americans have pension income.
Why Pensions Matter to Employers: They Are an Effective Recruitment and Retention Tool

DB pensions are an important recruitment and retention tool across industries. A 2008 survey found that 72% of employees cite retirement benefits as an important factor in their loyalty to their employer. Additionally, research has found that DB pension plans reduce turnover by 13 percentage points, and quit rates by 20 percentage points, on average.

Public sector managers, in particular, may benefit substantially from the human resource gains that DB pensions provide. Governments exist to provide essential services—safe streets, clean drinking water, good schools. These jobs tend to become quite specialized over time, which makes longer tenures beneficial.

Why Pensions Matter to Taxpayers: They Are an Economically Efficient and Prudent Use of Funds

DB plans are economically efficient. A recent analysis found that the cost to deliver the same retirement income to a group of employees is 46% lower in a typical DB plan than in a DC plan. This is because DB plans offer longevity risk pooling, a more balanced portfolio, and greater investment returns, on average, than DC plans.

DB pension plans also save governments money in reducing citizens’ need to rely on public assistance. In 2006, 4.7 million American households escaped “poor” or “near-poor” classifications due to their DB pension income. As such, some $7.3 billion in public assistance expenditures was saved.

Beyond Retirement: Why Pensions Matter to Local Economies and Capital Markets

Pension expenditures have a broad economic impact. In 2006, expenditures made out of public pension payments supported more than 2.5 million American jobs. Pension expenditures also supported over $358 billion in total economic output and over $57 billion in federal, state, and local tax revenue.

Also, because DB pensions are pre-funded, investment of pension assets provides “patient capital” to businesses to help develop products, invest in new technologies, and even create jobs.

Strong Public Pensions for Today and Tomorrow

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. Therefore, 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.

A critical measure for any funding effort is the 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 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.

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.

Funding and Investment Policies Can Support Predictability and Intergenerational Equity

One challenge to predictable, stable contribution rates is the cyclical nature of investment returns. Contribution burdens can be 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. Another approach to encouraging predictable contribution rates is to set a floor below which contributions may not fall, even when the plan is very well funded.

**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.

A critical method of maintaining roughly level contributions over time, which is fair to each generation, is the use of long-term projected rates of return in calculating pension costs. When determining contribution rates, actuaries apply their best estimate of long-term expected returns based on a plan’s underlying portfolio.

**Key Considerations in Benefit Policy**
For some employers, it may make sense to periodically update their benefit design. The cost (or savings) associated with such changes must be integrated with the plan’s funding policy in order for the changes to be consistent with the long-term health of the pension system. Government finance experts recommend that all benefit enhancements be actuarially valued before they are adopted to ensure a full understanding of their total cost.

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 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.

**Transparency and Fairness**
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.