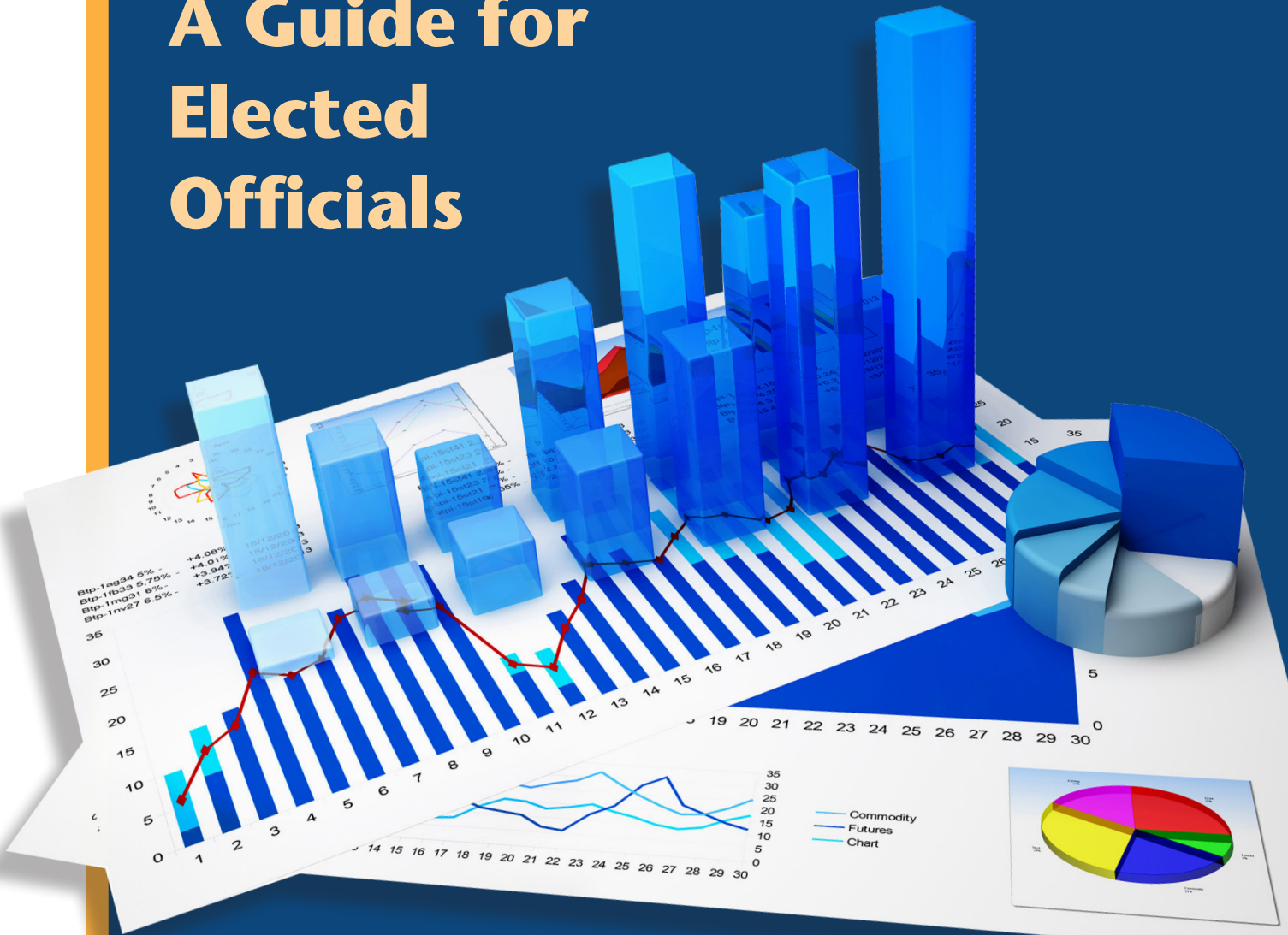


# Understanding Public Pensions

## A Guide for Elected Officials



April 2017

CENTER FOR STATE & LOCAL GOVERNMENT EXCELLENCE

AARP®

## Acknowledgments

This guide was written by Elizabeth Kellar with contributions from Bonnie Faulk, Joshua Franzel, and Amber Snowden from the Center for State and Local Government Excellence, and Barrie Tabin Berger, AARP. Amy Mayers was the copy editor, and the guide was designed by Susan Spangler. We are grateful to the National Association of State Retirement Administrators (NASRA) for their guidance and review of this document.



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# Understanding Public Pensions: A Guide for Elected Officials

## Introduction

State and local pension plans are important in attracting and retaining well-qualified public employees. They help to facilitate the effective and efficient delivery of public services by serving

**Not all changes  
are solutions.**

as a workforce management tool and providing financial security in retirement. As an elected official,

it is important for you to understand how public pension plans operate and the role they can play in meeting the needs of employees, employers, and taxpayers alike. A good starting point is to assess whether or not your pension plans are meeting their objectives.

The purpose of this guide is to provide key facts about public pension plans, including the elected official's role in making sure they are well designed

Public Plans — Quick Facts
<b>Cover</b> 14.7 million active (working) members
<b>Distribute</b> \$277.1 billion annually in benefits to 9.9 million retirees
<b>Hold</b> \$3.86 trillion in assets
<b>Financed</b> by employer and employee contributions and investment earnings

Sources: Public Plans Data (PPD) and Federal Reserve Flow of Funds

and adequately funded so they can meet the goals of all stakeholders.

You will quickly learn that since 2009 all states have made modifications to their retirement plans to help ensure their long-term sustainability. Every

## Retirement Plan Objectives

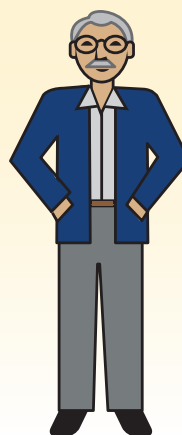
**Attract and Retain  
Employees**



**Enable Workers to  
Retire in Orderly Way**



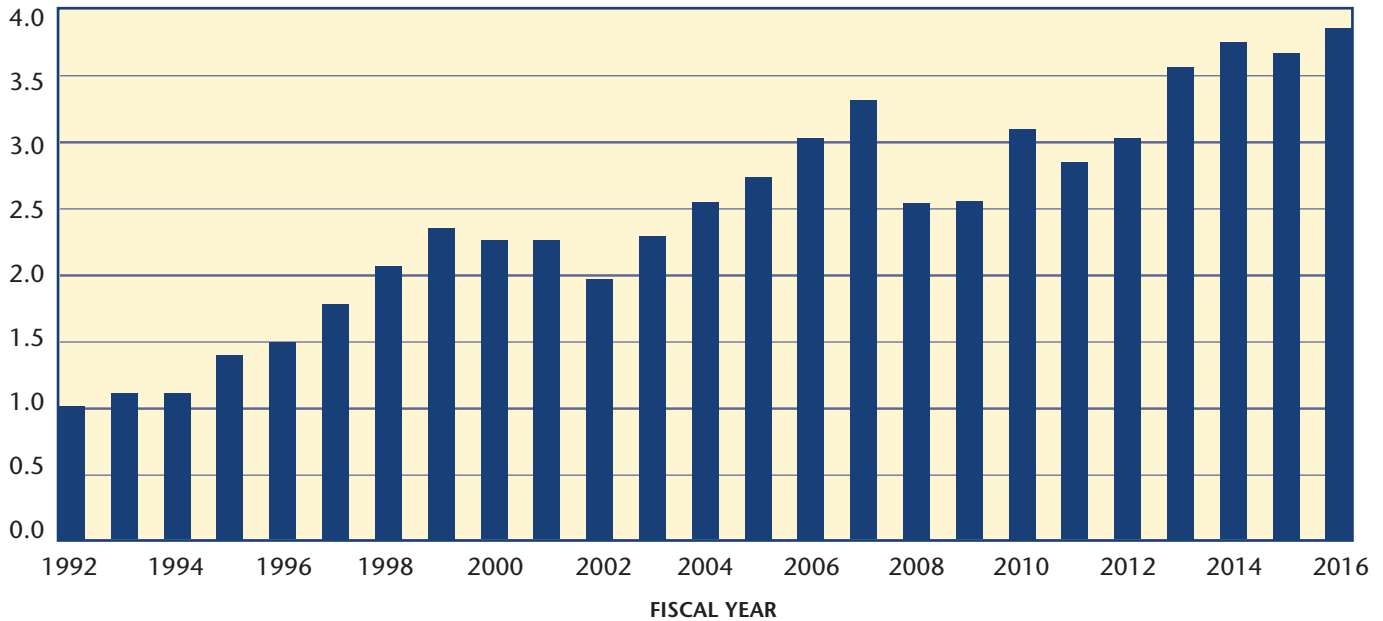
**Provide  
Retirement Security**



**Keep Costs  
Manageable**



### State and Local Defined Benefit Trust Assets Year-End, 1992-2016 (Trillions)



Source: Federal Reserve Flow of Funds

pension plan has a unique history, legal framework, and financial condition. As a result, there are no one-size-fits-all solutions from state to state or even from plan to plan to ensure that pension plans are properly financed and effectively managed to pay benefits for the long-term.

Finally, you will learn that not all changes are solutions. Any modifications to a pension plan should be carefully considered to avoid unintended consequences or costs.

## Understanding Your Pension Plan

As an elected official, you and your colleagues have important decisions to make about your government's retirement plans. An important first step is to familiarize yourself with your plan's purpose and how its design and funding mechanisms function.

Sound pension plan design and financing that balance stakeholder objectives likely will produce a sustainable retirement system able to pay benefits for the long term with fewer unintended or negative outcomes.

## Pension Plan Design

Retirement plan design can range from an employer maintaining sole responsibility for providing a guaranteed lifetime benefit to employees bearing the full responsibility to finance their own retirement savings. In plans for state and local government workers, retirement plan design falls somewhere between those two extremes.

There are three major types of retirement plans in the public sector: defined benefit, defined contribution, and hybrid plans.

### Defined Benefit

A defined benefit (DB) plan promises a specified monthly benefit at retirement, usually based on the employee's length of service and salary. Most state and local governments require both employers and employees to contribute to their defined benefit pensions while they are working. Typically, these plans are funded through a combination of employer contributions, employee contributions, and earnings from investments.

Public pension assets are held in a trust and invested in diversified portfolios to prefund the

cost of pension benefits. These pooled assets are professionally managed and provide economies of scale that lower fees and increase returns. Assets are then paid out in monthly installments during an employee’s retired years, not as a lump sum.

Typically, survivor and disability benefits are part of the financing and design of the defined benefit pension plan. Retirees also may be eligible for cost-of-living adjustments, which may be capped or dependent on the pension plan investment performance.

Defined benefit plans are the most prevalent plan design in the public sector. The typical defined benefit plan places some level of responsibility and risk on both the employer and employee. This use of shared financing and shared risk as part of plan design has grown in recent years as states have modified required employer and employee contributions, restructured benefits, or both.

Most state and local governments offer defined benefit pension plans to their employees, in part

because public sector workers generally have accepted more modest wages in exchange for more retirement security.

Retirement income also contributes to local and state economies as retirees spend their pension checks on goods and services where they live. Defined benefit plans in both the public and private sectors provide a reliable income for 24.3 million Americans. Nationwide, over \$1.2 trillion in total economic output resulted from DB pension expenditures in 2014. Reliable pension income is especially important in stabilizing local economies during economic downturns.<sup>1</sup>

### Defined Contribution

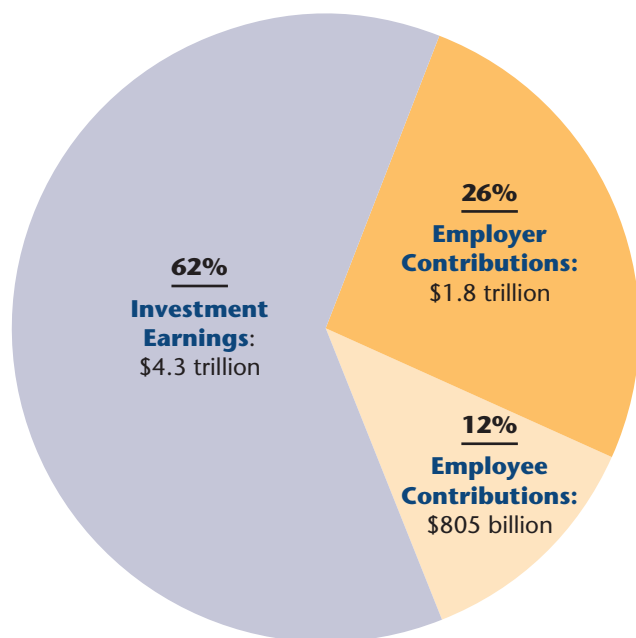
A defined contribution (DC) plan is a retirement savings vehicle that accumulates savings based on contributions to an employee’s individual retirement account. A DC plan does not promise a specific retirement benefit. In this plan design, the employee, the employer, or both contribute to the plan, often at a certain percentage of the employee’s salary. The employee will ultimately receive the balance in his or her account, which is based on contributions and any investment earnings. Defined contribution plans typically do not pool investments and employees are instead given a range of investment options they manage individually.

While 401(k)s are most prevalent in the private sector, they are not common in the public sector, where 401(a), 403(b), and 457 DC plans are typically used instead.

Although nearly all public employees have access to a DC plan as a supplemental savings plan, part of a hybrid plan, or as an alternative to a defined benefit plan, only a handful of states and the District of Columbia provide a defined contribution plan as their employees’ only retirement plan option.

In a defined contribution plan employees assume all of the investment and longevity risk. Employer obligations are fulfilled annually as contributions are made. Employers have some uncertainty about orderly retirements, particularly if investment returns drop and older employees decide to delay their retirement.

**Defined Benefit Public Pension Plan Sources of Revenue 1986-2015**



Source: Compiled by NASRA based on U.S. Census Bureau data

## Characteristics of Public & Private Sector Retirement Plans

PUBLIC	PRIVATE
99 percent of state and local workers have access to a retirement plan at work, and participation is typically mandatory. Additionally, most employees have access to a voluntary supplemental retirement savings plan—a 403(b) or 457 plan.	Roughly one-half of private sector workers have a retirement plan—usually a 401(k). A minority has a defined benefit or hybrid pension plan.
Pensions are in lieu of Social Security for 25 percent of the state and local workforce, including nearly half of teachers and two-thirds of public safety employees.	All private sector employees participate in Social Security.
Retirement benefits often include a cost-of-living adjustment (COLA).	Few private sector retirement benefits include a cost-of-living adjustment.
Nearly all employees are required to contribute to their retirement plan.	Private sector workers who are in defined benefit plans do not make contributions. Contributions to defined contribution plans are voluntary.
State and local retirement systems are established and regulated by state and/or local laws and must comply with federal tax and trust laws.	Private sector retirement plans are not governed by state and local laws, but rather are regulated by the federal Employee Retirement Income Security Act (ERISA) as well as other federal laws and regulations.
State and local governments follow the accounting standards set by the Governmental Accounting Standards Board (GASB).	Accounting standards and processes are set by the Financial Accounting Standards Board (FASB).

### Hybrid

Hybrid pension plans combine elements of both defined benefit and defined contribution plans. The two most prevalent types of hybrid plans sponsored by state and local governments are:

1. a combination of defined benefit and defined contribution plans and
2. a cash balance plan.

Combination plans typically include a modest defined benefit element in combination with a defined contribution plan.

Cash balance plans marry elements of traditional pensions with individual accounts into a single plan. Employers generally guarantee an annual rate of return on a hypothetical account to which the employer, employee, or both contribute.

### Balancing Stakeholder Objectives

Employees, employers, and taxpayers have a stake in your state and local government pension plans. Pensions are important to employers because they help to attract and retain well-qualified individuals to work in government. This is important because of the investment that employers make in the training and experience of their workers. Pensions allow employers to manage the progression of their workers throughout their career to ensure that public services are delivered effectively and efficiently, even as one generation retires and new employees are hired.

All stakeholders have a vested interest in retirees who are financially independent and do not require costly social services to meet their basic needs. For retirees, pensions are essential to help provide an adequate standard of living

throughout their retirement years. In addition, employers, employees, and taxpayers alike place a high priority on reasonable, predictable pension costs.

Meeting the needs of employees, employers, and taxpayers is challenging. Changes to the retirement plan that focus on one of these goals to the exclusion of others are likely to produce negative outcomes. Generally speaking, the following retirement plan core features have been successful in balancing the objectives of workforce management, retirement security, and costs.

- **Mandatory participation.** Most state and local governments require participation in the retirement program as a condition of employment.
- **Cost sharing between employers and employees.** Public employees typically are required to contribute 5 to 10 percent of their wages to their state or local pension.
- **Pooled and professionally managed assets.** Public pension trusts can earn higher returns

**Successful retirement plan changes follow a deliberative and informed process; engage employees and other stakeholders; keep the government competitive in recruiting and retaining employees; and rely on high quality data.**

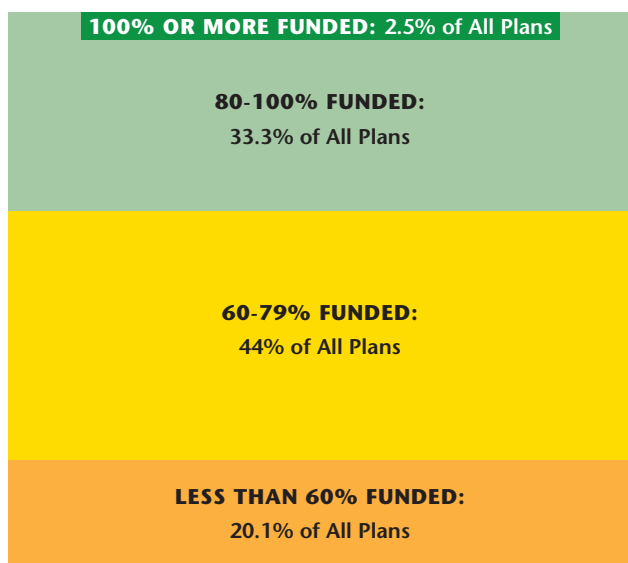
with lower fees through pooled investments that are professionally managed, have greater portfolio diversity, and large economies of scale.

- **Targeted income replacement.** Most public pension policies aim to replace a certain percentage of pre-retirement wages to better assure financial independence in retirement.
- **Lifetime benefit payouts.** The vast majority of state and local governments do not allow for a lump sum distribution of benefits; rather, they require retirees to take most or all of their pensions in installments over their retired lifetimes. Most also make periodic cost-of-living adjustments to curb the effects of inflation.

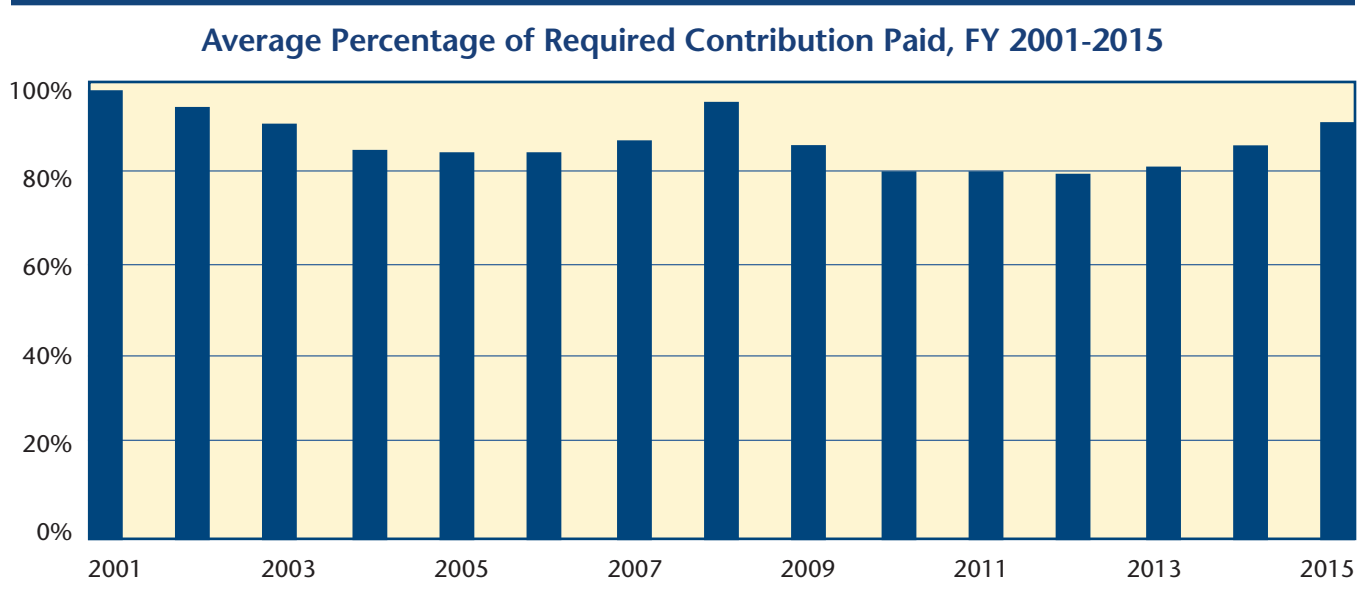
It is important to understand whether or not your plan is effective in balancing stakeholder objectives. You can start by gathering good data on your plan’s financial condition, what changes have been made to financing and design in recent years, and how those changes have affected all stakeholders. Good resources include your pension plan administrator, actuarial reports, and audited financials (Comprehensive Annual Financial Report).

Public Plans Data (PPD) is another good resource you can use to understand your plans in relation to national trend data. The PPD provides access to quick facts about public pensions at the national, state, system, and plan

### Nationwide Distribution of Funded Ratios for Defined Benefit Public Plans, FY 2015



Sources: 2015 actuarial valuations and calculations from PPD (2015).



Sources: 2015 actuarial valuations and PPD (2001-2015)

levels, as well as data on plan contributions and assumptions (<http://publicplansdata.org>).

It is important to understand if your government has been making its full actuarial contribution as well as any recent adjustments to employer and employee contributions, benefit levels, or eligibility for retirement.

From 2009 to 2015, in the wake of the Great Recession, every state made meaningful changes to one or more of its pension plans. Although the market crash and the recession affected all plans, plan changes varied because of differing designs, budgets, and legal frameworks across the country. Each state or local government made modifications that were tailored to its unique circumstances. It is noteworthy that nearly every state chose to retain its traditional defined benefit pension plan and the core features that balance workforce management, retirement security, and cost containment sought by employers, employees, and taxpayers. Only five states (Michigan, Rhode Island, Tennessee, Utah, and Virginia) created combination hybrid plans.<sup>2</sup>

The most common change to pension plans during this time was an increase in employee contributions. Increases in contributions often have applied to both current and new employees.

Other plan changes, such as increasing the retirement age, typically have applied to new employees. Some plans reduced or eliminated automatic cost-of-living adjustments or reduced the amount of income replaced in retirement for each year worked.<sup>3</sup>

Retirement plan changes that are successful in preserving a sustainable pension to pay benefits for the long term follow a deliberative and informed process, engage employees and other stakeholders, keep the government competitive in recruiting and retaining employees, and rely on high quality data.

## Public Pension Financing

Prefunding pension benefits ensures that sufficient assets will be accumulated during an employee's working years so that benefits can be paid when the employee retires. Governments that have had success in reaching their funding goals take a long view and are disciplined about funding their required contributions on an annual basis.

Although media reports draw attention to poorly-funded pension plans, there is wide variation in the funded status of defined benefit plans across the country: 36 percent are more than 80 percent funded and only 20 percent are under 60 percent funded. Overall, pensions were 74 percent



If your pension plan is underfunded, you can't change the past, but you can change the plan's future direction.

funded on average in 2015, according to funding measures used for actuarial reports.<sup>4</sup>

Many factors can affect the funded status of a pension plan, including the government's pension funding policy, investments, assumptions, as well as legal limitations and cost implications related to benefit changes.

### Funding Policy

Governments should have a clear pension funding policy that lays out a plan to fully fund pension benefits within a reasonable time period. A sound pension funding policy offers guidance in making annual budget decisions, documents prudent financial management practices, and provides transparency as to how and when pensions will be funded.<sup>5</sup>

Governments that are disciplined in following such pension funding policies and make their full employer contributions every year remain well funded, even following market downturns and recessionary periods.

A pension funding policy should incorporate certain general objectives to:

1. Base the employer's annual contribution on an actuarially determined contribution (ADC), calculated at least every two years.

## Taking Stock of Good Pension Practices and Policies

**Has the plan been historically well financed because the government has been making its pension payment in full each year and/or have new financing mechanisms been put into place?** Gather facts and review the pension funding policy, employee and employer contribution history, changes for new employees, and current and trend data on the funded status of plans.

**Is the plan design meeting the human resource, financing, and retirement security needs of stakeholders?** Examine elements such as benefit levels, vesting, and the minimum age and service required to receive a retirement benefit.

**If there are cost concerns, are they from past liabilities or new pension benefits?** Verify whether the costs of the plan are primarily due to past unfunded liabilities, which cannot be erased, or to ongoing benefit accruals.

**Are the plan's assumptions in line with its experience?** Determine if assumptions (e.g., long-term investment returns and plan demographics) are regularly reviewed to ensure they accurately reflect the plan's experience and any needed adjustments can be made in a timely way.

**Are benefit improvements fully funded?** Ensure that any increases in benefit levels or cost-of-living adjustments do not increase the plan's unfunded liabilities.

**Are there legal and cost implications to pension modifications?** Research whether legal restrictions may bar certain plan changes and whether they may increase plan costs or have unintended consequences.

**Are there inequities that create hidden costs and undermine public trust?** Eliminate any practices that could allow a few individuals or employers to undermine the funding of the system.

Annual Return for State and Local Pensions, 1992-2015		
	Actual Annual Return %	Assumed Annual Return %
1992	10.17	8.22
1993	0.01	8.21
1994	10.88	8.20
1995	11.31	8.17
1996	14.54	8.15
1997	16.76	8.15
1998	17.45	8.15
1999	12.13	8.11
2000	15.50	8.07
2001	1.34	8.05
2002	2.22	8.03
2003	3.14	7.98
2004	17.18	7.95
2005	9.48	7.93
2006	11.20	7.92
2007	15.71	7.91
2008	-3.47	7.90
2009	-20.90	7.88
2010	14.11	7.79
2011	17.64	7.68
2012	2.98	7.65
2013	10.71	7.61
2014	15.83	7.62
2015	5.54	7.58

Source: Census of Governments. National data averages are weighted by plan size.

2. Commit to funding the full ADC each year. If a plan is significantly underfunded, this may require a transition period for some government employers to achieve.
3. Provide clear reporting to show how and when pension plans are projected to reach full funding.

## Investments

State and local government defined benefit pension plans hold \$3.86 trillion in assets in trust for current and future retirees. These assets are professionally managed and pooled, which reduces costs, allows greater portfolio diversity, reduces risk, provides economies of scale, and produces higher investment returns.

Pension fiduciaries and trustees have the primary responsibility for establishing the plan's investment policy and strategy. They establish the asset allocation plan, select the investment team, negotiate fees, and monitor the strategy.

## Assumptions

Another characteristic of well-funded pension plans is that they carefully monitor their assumptions to ensure they accurately reflect the plan's experience and that any needed adjustments can be made in a timely way. In a defined benefit pension plan, employers rely on actuarial assumptions to determine how much they need to contribute (or prefund) each year to ensure that benefits can be paid when employees retire. Actuaries base this calculation on numerous economic and demographic assumptions.

Economic assumptions include inflation, salary growth and investment returns. Demographic assumptions include the age when employees retire and how long they will live, among others. Using these assumptions, actuaries develop projections regarding the level of pension fund assets required to pay future liabilities and the required contribution governments need to budget to bring the fund into balance over a fixed number of years.

An actuarial experience study should be conducted at least every five years so that actuarial assumptions can be updated. These studies help to ensure that assumptions are in line with the plan's demographic and economic experience.<sup>6</sup>

## Benefit Changes

Before considering benefit changes to your government’s pension plans, assess your overall goals, the effect of the various proposals on the workforce and the employees, and resulting financial impacts. Examine any legal limitations and cost implications. For example, state laws, including constitutional restrictions, statutory provisions, or case law, often protect benefits that current employees have already earned. Many also limit or prohibit changes that negatively impact future benefit accruals for current employees.

You also need to gather data on the plan’s funded status, the government’s contribution history, what changes have been made in recent years, and whether those changes have had a sufficient chance to take effect, as well as understanding your plans in relation to national trend data.

If your pension plan is underfunded, you can’t change the past, but you can change the plan’s future direction by realigning contributions and/or benefit levels.

While there is more flexibility to modify benefit levels for new employees, such changes will not affect unfunded liabilities that have already been accrued. Placing new employees into an entirely different plan type may also have unintended consequences, including accelerating pension costs

### Pension Measures for Different Purposes

Several separate pension calculations are derived in different manners for distinct purposes:

**Accounting:** The GASB calculations used for annual financial reports.

**Budgeting:** The actuarial calculation that determines how much the government needs to contribute to advance-fund future benefits.

**Bond ratings:** Credit rating agencies use their own proprietary analytics to calculate pension obligations.

[http://www.gfoa.org/sites/default/files/GFR\\_APR\\_13\\_70.pdf](http://www.gfoa.org/sites/default/files/GFR_APR_13_70.pdf)

in the closed (legacy) plan. There are also additional administrative costs associated with operating two types of pension plans. Workforce issues, such as the potential of increased turnover and training costs, should be carefully considered.

Elected officials sometimes seek to increase pension benefit levels. When such changes are approved, be sure they are fully funded. For example, retroactive benefit and cost-of-living increases that are not fully funded will increase the plan’s liabilities.

Another challenge can occur if pension rules permit employees to increase their final salary to the detriment of the plan’s funding (e.g., include overtime pay in the benefits formula).

Such practices can disproportionately increase an employee’s pensionable compensation and create inequities and hidden costs. These types of pension increases can also undermine the public’s trust in the government and create a false impression of a typical public employee’s retirement benefit.

To change direction, start by examining the current situation. Are your pension plan benefit levels appropriate to achieve your objectives? Has the government been making the full employer contribution? Are your plan’s vesting as well as age and service requirements for receiving a pension appropriate? Are there inequities that need to be

Pension Funding Checklist	
<input checked="" type="checkbox"/>	Budget for the full employer contribution.
<input checked="" type="checkbox"/>	Adjust employer and employee contributions as needed.
<input checked="" type="checkbox"/>	Evaluate benefit levels and eligibility to receive benefits.
<input checked="" type="checkbox"/>	Conduct actuarial experience study.
<input checked="" type="checkbox"/>	Adjust investment and demographic assumptions as needed.

**Governments that develop a credible funding plan and stick to it have the most success in achieving their pension goals.**

can be made in a timely way. Improving a pension plan’s funded status can be achieved with discipline and commitment.<sup>7</sup>

As more older workers retire and a younger generation moves into the government workforce, attracting and retaining well qualified individuals is more important than ever. Elected officials play a key role in balancing stakeholder objectives to produce a sustainable retirement system that is both competitive and cost-effective.

corrected? Do any of your plan’s assumptions need to be adjusted based on actual experience?

Governments that develop a credible funding plan and stick to it have the most success in achieving their pension funding goals.

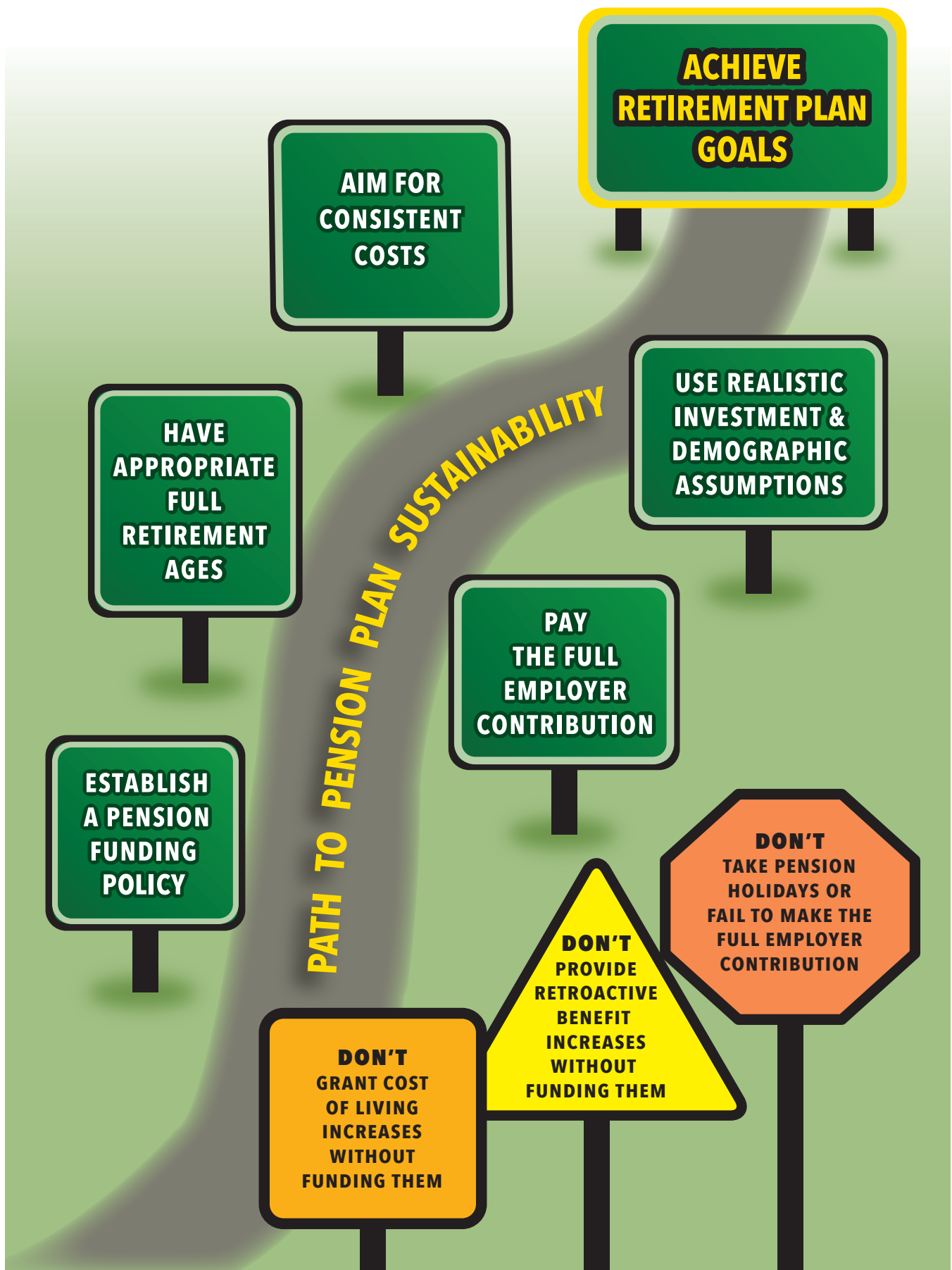
**Strategies for Success**

Every state and local pension plan has its own history, legal framework, and characteristics. That’s why solutions to pension funding and other challenges must be tailored to the individual needs and circumstances of participating employers and workers. If changes are needed, keep in mind the objectives of the pension plan, including workforce management, retirement security, and costs.

In examining pension plans that are well funded, certain strategies stand out. Without exception, these pension plans have been able to count on the employer contribution. These governments rarely, if ever, take a pension holiday, making their full contribution whether the stock market is up or down. If they need to make changes to their pension plan design, they do so based on good data; engage all stakeholders as changes are considered; and do not lose sight of their pension plan objectives. Some of them have increased the age and/or service requirements needed to receive a pension and many have increased both employer and employee contributions when needed. Cost-of-living adjustments are funded whenever granted, as are benefit enhancements.

Finally, they are rigorous in examining their assumptions to ensure they accurately reflect the plan’s experience and that any needed adjustments

Takeaways
Key retirement plan objectives include attracting and retaining employees, workforce management, retirement security, and keeping costs manageable.
To balance objectives, consider a retirement plan that includes the core features of mandatory participation, cost sharing, pooling of contributions, professional asset management, targeted income replacement, and lifetime benefit payouts.
Before making any changes to your retirement plan, be mindful of your overall goals, the effect of various proposals on the workforce and the employees, and resulting financial impacts.
Successful retirement plan changes follow a deliberative and informed process, engage employees and other stakeholders, keep the government competitive in recruiting and retaining employees, and rely on high quality data.
From 2009 to 2015, nearly every state made changes to its pension plans, yet most retained a traditional defined benefit pension plan with some modifications.
If your pension plan is underfunded, you can’t change the past, but you can change the future direction by making the full employer contribution going forward and by realigning contribution and/or benefit levels.
Retirement plan funding and solutions must be tailored to the individual needs and the circumstances of participating employers and workers.
Communicate! Give employees and the public clear information about pension finances and the plan to fund them.



## Endnotes

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<http://slge.org/publications/pension-funding-a-guide-for-elected-officials>
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### FOR MORE INFORMATION

**Center for State and Local Government Excellence**

[slge.org](http://slge.org)

**Government Finance Officers Association**

[gfoa.org/sustainable-funding-practices-defined-benefit-pensions-and-other-postemployment-benefits-opeb](http://gfoa.org/sustainable-funding-practices-defined-benefit-pensions-and-other-postemployment-benefits-opeb)

**National Association of State Retirement Administrators**

[nasra.org](http://nasra.org)

**National Conference of State Legislatures**

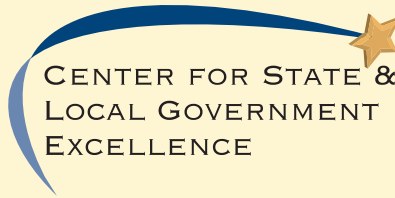
[ncsl.org/research/fiscal-policy/pensions.aspx](http://ncsl.org/research/fiscal-policy/pensions.aspx)

**Public Plans Database**

[PublicPlansData.org](http://PublicPlansData.org)

**National Institute on Retirement Security**

[nirsonline.org](http://nirsonline.org)



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