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Frequently Asked Questions about Pensions

FAQ

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**.

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.

How are benefits earned?

In a traditional DB pension plan, coverage is universal; all eligible employees are automatically enrolled in the pension plan. Typically, after an employee has worked a certain number of years, his or her right to receive a pension benefit becomes "vested," meaning that s/he has a legal right to receive benefits. Years of service before vesting are included in the calculation of the pension benefit in retirement.

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. Under this design, the plan may provide a benefit multiplier of, for example, 2.0% of pay. If an employee works for 30 years and has a final average salary of $40,000, this employee's annual pension income will be $24,000 (40,000 x 30 x 2.0%), which translates to a pension income of $2,000 per month.

What do pensions mean for employees?

Especially for middle-income retirees, DB pension income remains an extremely significant source of retirement income. Retirees in the third and fourth 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.

How are pensions funded?

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 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.

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.

To ensure that the plan will have enough assets to pay future benefits, it is important that the annual required contribution (ARC) be contributed to the pension trust each year.

Is it important to fund the pension each year?

Yes. It is important that the actuarially required contribution (ARC) be contributed to the pension trust each year, for several reasons. Firstly, if a plan does not fully fund the ARC every year, the plan is likely to become underfunded, which means that the plan's assets will not cover all of the plan's current and future liabilities. Postponing payments will only increase the ARC in future years, because the ARC will now consist of both the normal cost and a portion of the unpaid liabilities from past years, also called the unfunded actuarial accrued liability (UAAL).

Secondly, if progress is not made toward closing the plans' funding gap over time, the plan sponsor runs the risk of being seen as a greater credit risk; it can be given a lower credit rating, and when this happens, the cost of borrowing increases.

Finally, if a plan is chronically underfunded for a substantial period of time, it may actually run the risk of not having enough assets to pay out current liabilities—in other words, there may not be enough funds in the pension trust to cover payments that must be made to current retirees. In this scenario, the plan is no longer a pre-funded system and becomes a pay-as-you-go system, in which current payments are made out of the current revenues.

Public pension plans as a group have been diligent about pre-funding, especially in recent years. Recent investment losses are presenting challenges but most plans will be able to recover with modest adjustments.

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. In the aggregate, state and local pension plans' asset allocations look quite similar to those of pension 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.

Who has a pension?

Of the 31.6 million older American households in 2006, about half had income from a DB pension. Of older households with pension income, 9.4 million had pension income from a private sector job, 3.9 million had pension income from a public sector job, and 1.7 million households had both public and private sector pension income.

Among current U.S. workers with a DB pension plan, there are currently more private sector employees with pensions than public sector employees. In 2007, 21 million private-sector American workers had a workplace DB pension plan, while state and local pension plans served 14.2 million workers. In 2005, among those with a workplace retirement plan, 98% of public sector employees had a DB pension, as compared with just 33% of private sector workers.

Who is most likely to have a pension?

In the private sector, those workers who are unionized, working for large firms, and/or full-time employees are in general more likely to have DB pension coverage than those who are nonunionized, working for small firms, and/or work part-time.

Among demographic groups, white men are still more likely to have DB pension income than women and members of racial and ethnic minority groups. However, when racial/ethnic minorities and women do have a pension, their pension income plays a unique role in shrinking gender and racial/ethnic income gaps in retirement.

How much pension income do people usually receive?

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.

The median amount of public pension income was $20,947, while the median amount of private pension income was $8,739. This may be because public employees, unlike private sector workers, contribute to their pensions. Also, public sector workers tend to have longer job tenures than those in the private sector, which can lead to higher pension income. Finally, benefits may be greater to compensate for lack of Social Security coverage in the public sector.

What have been the pension trends over time?

Over the past 25 years, traditional pension coverage has been on the decline in the private sector. In 1975, of employees with a retirement plan at work, 88% of private sector workers were covered by a DB pension plan; by 2005, that number dropped to just 33%.

The public sector, by contrast, has been able to maintain DB coverage for the vast majority of its employees because each of the reasons for the private sector decline has little relevance to the public sector.

Why has coverage declined so much in the private sector?

There are several reasons for the decline in private-sector DB participation. First it seems that many employers may not realize just how highly their employees value pensions. If employers believe that employees do not value DB pensions, they may not see a good enough reason to continue to offer such a plan.

Secondly, the private sector has seen significant regulatory changes to single-employer DB plans in the past few decades, which have had the unintended effect of making the DB plan less attractive to many employers.

Thirdly, industry shifts and technological changes that the private sector has seen in the past several decades may have contributed to the decline in DB coverage as well. As unionized industries such as manufacturing have declined, newer industries have sprung up, such as information technology, which tends to employ nonunion and shorter-tenured employees. These new industries have not taken up DB pension plans as much as the more established industries.

Why do pensions matter to employees?

Retirement researchers have long acknowledged the importance of the so-called "three-legged" stool—of Social Security benefits, defined benefit (DB) pension income, and supplemental individual savings—in providing Americans the greatest opportunity to achieve financial security in retirement.

Very specific characteristics of traditional DB pension plans make them very effective at supporting retirement security for the middle class. First and foremost, DB pensions provide lifetime income. Also, DB pensions are broad-based and secure sources of retirement income. Finally, DB pension plans provide ancillary benefits such as spousal protections and disability benefits.

How do pensions help Americans achieve retirement readiness?

DB pension income plays a substantial role in ensuring that Americans remain self-sufficient in retirement. Income from DB pensions helped 4.7 million older households avoid being below or close to the poverty line in 2006.

Are defined contribution plans by themselves adequate?

The private sector trend away from DB pensions and into DC plans is having a negative effect on retirement prospects for many Americans close to retirement.

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 a pre-retirement standard of living after they stop working. In other words, having a DC plan does not seem to reduce retirement risks at all. 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.

Thus, Americans with DB pension income are much more likely to achieve financial security in retirement than those without such pensions.

How do pensions help women and minorities?

Women and racial and ethnic minority groups are more at risk in retirement than their white male counterparts for two reasons. First, they still make less money over their careers, and second, they have less access to workplace retirement plans.

Yet DB pension plans seem to play a unique role in shrinking these gender and racial/ethnic gaps in retirement. That is, the percentage of American households classified as poor and near poor drops across gender and race categories when older Americans have pension income.

Why do pensions matter to employers?

DB pension plans are extremely valuable to employers who have specific human resource goals for their workforces. Because of their deferred nature, retirement benefits encourage employees to stay with an employer. In a traditional, final pay-based pension plan, workers earn benefits more rapidly the longer they stay on the job; this leads to higher rates of retention.

How much do workers value their pensions?

Employees value DB pension plans highly and are more committed to employers who offer them. A 2008 MetLife survey found that 72% of employees cite retirement benefits as an important factor in their loyalty to their employer. Among employers, a 2004 survey found that 84% of DB plan sponsors believe that their pension plan has a positive impact on employee retention.

Public sector employees in particular prefer DB plans to other forms of retirement income, as well as care more about their retirement benefits in general, than private sector workers. One survey found that public employees much preferred traditional DB pensions, and were much less likely than other workers to express a preference for DC plans.

Are pensions an effective recruitment and retention tool?

Yes. DB pensions are an important recruitment and retention tool across industries. One study found that workers with pensions are 17% more likely than workers without pensions to stay at their jobs in a single year, all else equal. Another found that firms with pension coverage saw lower turnover rates than non-pension firms. Other research has found that DB pension plans reduce turnover by 13 percentage points, and quit rates by 20 percentage points, on average.

How is increased recruitment and retention beneficial to public sector employers?

Public sector managers may benefit substantially from the human resource gains that DB pensions provide. Unlike private companies that exist to make a profit for shareholders, governments exist to provide essential services—safe streets, clean drinking water, good schools—to citizens and residents. These jobs tend to become quite specialized over time, which makes longer tenures beneficial. DB pension plans are able to help reinforce public sector employers' human resources goals to recruit and retain a qualified, highly skilled workforce necessary to deliver public services.

Why do pensions matter to taxpayers?

All American taxpayers have an interest in ensuring that all workers can retiree with an adequate retirement income. With regard public pensions, these plans enable government employers to recruit, retain and retire a qualified workforce that provides essential public services—educators, police officers, firefighters, scientists, health professionals among others. When compared with other types of retirement benefits, pensions are the most economically efficient and prudent use of taxpayer funds. Research indicates that a DB pension can provide the same retirement benefit at half the cost of an individual DC account. Moreover, public sector employee contributions and investment returns have historically paid for nearly 80% of retirement benefits, with taxpayer covering only about 20% of the cost.

Are pensions more economically efficient than defined contribution plans?

Yes. A recent analysis of the cost to achieve a target retirement benefit under both a DB and DC structure found that a DB plan cost nearly half as much as the DC plan. That is, the cost to deliver the same retirement income to a group of employees is 46% lower in the DB plan than in the DC plan.

The reason for such cost savings is threefold. Firstly, because DB plans pool the longevity risks of large numbers of individuals, they need only accumulate enough funds to provide benefits for the average life expectancy of the group. Secondly, DB plans are able to take advantage of the enhanced investment returns that come from a balanced portfolio over long periods of time. Thirdly, DB plans achieve greater investment returns than DC plans.

Are there any other reasons why DBs might be a good deal for taxpayers?

Yes. DB pension plans also save governments money in reducing citizens' need to rely on public assistance. A recent study finds that DB pensions have been instrumental at keeping elder Americans out of poverty. In 2006 poverty rates among older households lacking pension income were about six times greater than those with such income. Also, 560,000 fewer households experienced a food hardship, 380,000 fewer households experienced a shelter hardship, and 320,000 fewer households experienced a health care hardship because they had income from a pension.

When fewer households experience poverty and financial hardship, federal, state, and local governments see a cost savings in terms of public assistance expenditures avoided. The report calculates a savings of some $7.3 billion in public assistance expenditures in 2006 attributable to receipt of pension income. In the absence of DB pensions, spending on public assistance for the elderly would be about 40% higher than we actually observe.

How do pensions fit into the broader economy?

The economic impact of DB pensions reaches well beyond the retirees who receive pension checks. DB pensions play a vital role in the national economy as well as in local economies across the country, largely due to two different types of economic channels: the benefit channel, in which retirees' expenditures create incomes for others in the economy, and the investment channel, in which the investment of pension assets provides capital to businesses. Each of these impacts is substantial.

What is the macroeconomic effect of expenditures from DB pension income?

Expenditures made out of DB pension plans have a broad economic impact, both nationally and on the local level. In 2006, expenditures made out of public pension payments supported more than 2.5 million American jobs that paid more than $92 billion in total compensation. Pension expenditures also supported over $358 billion in total economic output nationwide and over $57 billion in federal, state, and local tax revenue.

State and local pension expenditures also have large multiplier effects. For each dollar paid out in pension benefits, $2.36 in total economic output is supported. And for every dollar contributed by taxpayers to state and local pension funds, $11.45 in total output is supported.

What effects do pension investments have on capital markets?

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

DB pensions have longer time horizons than savers in DC plans, and because of this they can achieve greater stability in asset allocations. This "patient capital" offers benefits for financial markets, since professional investors who follow a long-term strategy are less likely to cause market disruptions by chasing short-term returns.

What are the effects of the economic downturn on pensions?

The historic stock market decline of 2008 has impacted and presented challenges for all investors, including pension plans. Yet the downturn has also highlighted how critical pensions remain in addressing the retirement security challenges for Americans. Indeed, Americans without pension income who must rely solely on their DC assets and Social Security face the biggest challenges.

Also, despite the market impact, most public pensions have sufficient assets on hand to pay benefits for many years, even decades, without making fundamental changes to plan designs or benefit levels. However, many plans—either formally or informally—are evaluating benefit levels and financing structures to ensure long-term sustainability. Plans' long funding horizons provide time to consider options and to make modifications.

Indeed, as the full effects of the economic downturn continue to come to light, plans will continue to assess the path forward to ensure the plans can continue to provide a modest retirement benefit in fiscally responsible manner.