NRTA PENSION EDUCATION TOOLKIT

Public Pension Fact Sheet

Highlights...

- Pensions serve 4.5 million public sector and 10 million private sector retirees. They are a critical lifeline to America's middle class seniors.
- Group pension plans provide guaranteed, monthly income for life, enhancing retirement security for those who have them. COLAs help protect the value of the benefits retirees have earned.
- Pensions are the most economically efficient way to fund retirement, making them a good use of taxpayer dollars.
- Pension expenditures also help to boost local economies, especially in tough economic times, making them good for local businesses nationwide.
- Public pension plans—like all investors—have taken a hit in the economic crisis, but are well-positioned to recover. Most funds were well-funded before the crisis, and DB plans have achieved superior investment returns even during the crisis.
- Even so, pension contributions are likely going up, and other changes are being made to ensure sustainability. The good news is that these should be quite manageable in most states, especially those that have made their full contributions in past years.
- Because of the long-term nature of pensions, funding gaps can be filled gradually, over time.
- States that have studied the issue have concluded that continuing to provide retirement benefits via DB pension plans meets the joint interests of fiscal responsibility for employers and taxpayers, and retirement security for employees.

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Pension Plans Deliver for Employees, Employers, and Taxpayers

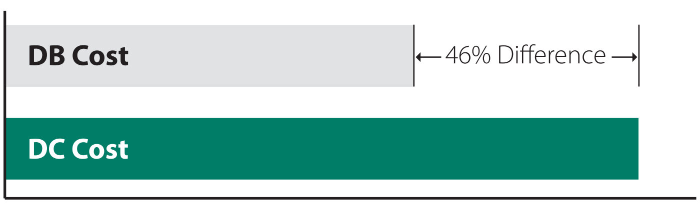
Traditional, defined benefit (DB) pensions are vitally important to the retirement security of middle class Americans. State and local government pension plans serve more than 19 million current workers and retirees, while private sector pensions serve an additional 31 million retirees and active workers.[1]

Group pension plans provide reliable, monthly income for life, which makes retirement security much more achievable for Americans who have them. While defined contribution (DC) plans were meant to be supplements and were not designed to replace DB pension plans, unfortunately, there has been a gradual trend in the private sector away from group pension plans and toward DC plans, such as 401(k)s.

This trend has been devastating for the retirement prospects for many Americans. One study found that, on average, middle-class Americans without a pension will have to reduce their living expenses by a full third in order to avoid outliving their assets in retirement.[2] The National Institute on Retirement Security found that older households lacking DB income were about six times more likely to be in poverty than those households who had DB income.[3] Finally, Boston College researchers have found that having a DC plan only reduces retirement risks slightly, if at all.[4]

DB pensions often provide other benefits as well, such as disability benefits, spousal protections, and cost of living adjustments (COLAs), each of which makes DB plans unique. COLAs in particular are important for retirees, because inflation can very quickly erode the value of retirement income. COLAs do cost money, however; any COLA benefits that are promised should be pre-funded or paid for in the year that they are given.

Cost to Achieve a Target Benefit in Retirement



Not only are pensions so good at providing retirement security, but they are also a good deal for taxpayers, because they are an economically efficient way to fund retirement. By pooling and professionally managing assets, DB plans are able to achieve economies of scale. Research has found that a group pension can achieve a target retirement benefit at about half the cost of DC accounts.[5]

Pensions also help to boost local economies, especially in tough economic times. In 2006, expenditures made out of public pension benefits supported more than 2.5 million new American jobs and over $358 billion in total economic output nationwide.[6]

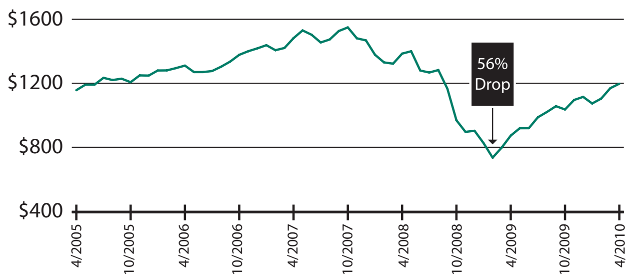
Financing Pensions is a Shared Responsibility

Another reason why pensions work well is because they are "prefunded" systems—regular contributions for each employee are made into a retirement fund during the course of that employee'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.[7]

Thanks to pre-funding, investment returns have historically made up the bulk of public pension receipts. Over the past 15 years, about 68% of receipts came from investment earnings alone. Another 11% came from employee contributions, and about 21% came from employer (state) contributions.[8]

The Economic Crisis and Public Pensions

Figure 1. **Performance of the Standard & Poor 500 Index**



Pension plans were not immune from the recent stock market decline that began in the fall of 2007 and lasted through the spring of 2009. When the Standard & Poor 500 Index fell 56% between October 2007 and March 2009, like all investors, pension plans were hurt.

Public pension holdings fell in value by $889 billion between 2007 and 2008. Since that time, as the stock market has rebounded, so has the value of public pension funds—their holdings increased by $346 billion by the end of 2009.[9] But those gains have not fully made up for the huge prior losses.

At the same time, the economic crisis has also negatively impacted state budgets. States have implemented various changes in order to balance their budgets in 2010, including furloughs and layoffs for state employees.[10] Significant challenges remain. By and large, however, public plans are positioned to recover well, for two main reasons.

First, as a group, most states have been diligent about funding their pensions, especially in recent years. On average, about 88% of the annual required contribution (ARC) was received by the largest state and local retirement systems in the country. Most funds (about 6 in 10) received payment for the full amount of their ARC or something close to it in 2008.[11] As a result, most public pensions have enough money on hand to keep paying benefits for decades.[12]

Secondly, DB pension plans weathered the financial storm better than other investors, particularly, individual investors in DC plans. A recent analysis by the consulting firm Towers Watson found that DB plans outperformed DC plans in 2008,[13] continuing a long-term trend of superior investment returns.

Pension Obligations Are Manageable

Even with pre-funding, unfunded pension liabilities can sometimes emerge, especially in the wake of a stock market drop. It's important to distinguish between plans whose funding gaps are the result of recent market conditions and those where there has been a lack of funding discipline. Today, even states that have done a good job of keeping up with their pension contributions in the past are facing growing contribution requirements, due to the recent economic downturn.

But some plans face greater challenges. In the past several years, some governmental employers have failed to contribute their full ARC. If a state or city fails to make contributions on time and in full, pension costs will almost assuredly increase in later years.[14]

Unfunded liabilities do need to be filled, but they may not be so problematic, depending on the specifics of each plan. If the plan is able to continue to pay promised benefits and the employer can make its required contributions without causing fiscal stress, then the funding gap can be closed gradually.[15] In fact, funding gaps do not need to be closed in a single year, but the payments can be amortized over a number of years. Governmental accounting standards permit a pay-down period of up to thirty years.

For most states and localities, filling funding gaps will be manageable. Researchers at Boston College project that if total contributions increase by just 2.2 percent of payrolls on average, state and local governments can pay off the total unfunded liabilities in 30 years.[16]

Meanwhile, legislatures around the country are generally taking a careful approach to examining benefit levels and financing structures to ensure that pension plans will have what they need to be sustainable over time. Uniqueness in plan design, benefit structure, and governance arrangements may dictate different responses among different systems.[17]

According to the National Conference of State Legislatures, the actions taken by states to date have been quite substantive and varied. Measures have included increasing employee contributions; changing the benefit calculation in some way; increasing age and service requirements; implementing provisions to limit "spiking" abuses; changing post-retirement increases; and increasing the vesting time period.[18]

Across the nation, states and localities remain committed to their pensions, largely rejecting proposals to substitute DC plans for pensions.

Keeping the Promise

Preventing funding gaps from occurring and closing gaps that do emerge is hard work, and requires a disciplined approach to pension fund stewardship. The good news is that a well-managed group pension plan is still the most economical way to achieve retirement security.

In fact, time and again, states that have carefully studied the issue—such as Kansas, Maine, New Mexico, and Rhode Island—have concluded that, even in tough economic times, continuing to provide retirement benefits via cost-effective group pension plans meets the joint interests of fiscal responsibility for employers and taxpayers, and retirement security for employees.

The bottom line is that DB pensions are a critical lifeline to America's middle class seniors. More than 4.5 million retired public employees and nearly 10 million retired private sector employees rely on a pension to make ends meet.[19] Keeping these vital systems healthy should be a high priority for decision-makers at every level, so that pensions can continue to keep the promise for future generations.

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