NRTA PENSION EDUCATION TOOLKIT

Pension Contribution Requirements

In thinking about pension contribution requirements, remember that…

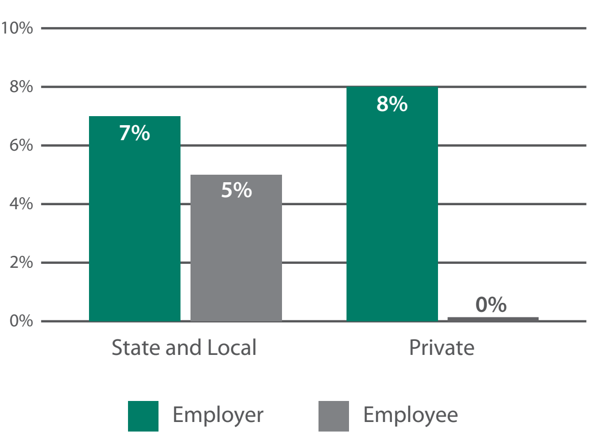
- Pension plans are "prefunded," which means that regular contributions for employees are made into a retirement fund during their careers.
- Keeping the pension plan well-funded is typically a shared responsibility between employees and employers. Investment returns make up the bulk of pension fund receipts.
- Some governmental employers have failed to contribute the amount of money to the pension fund that they should. Pushing contributions into the future increases the cost in later years.
- With the stock market downturn, pension contributions may be going up. But these additional contributions should be manageable in most states.
- Pensions are still the most efficient way to fund retirement benefits for public employees.

With the economic downturn of 2008 and 2009, many states and municipalities are facing 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

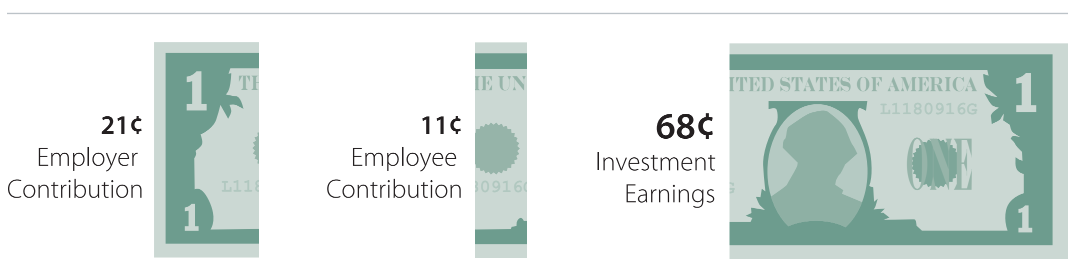
Pension plans are pre-funded, which means that regular contributions for each worker are made into a retirement fund during the course of that worker's career. In most state and local pension plans, these contributions come from both employers (the city or state) and employees, who contribute to the 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]



On average, public sector employees contribute 5% of each paycheck to their pension. Employers contribute 7%. In the private sector, employers contribute 8% 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. 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 contributions.[3]

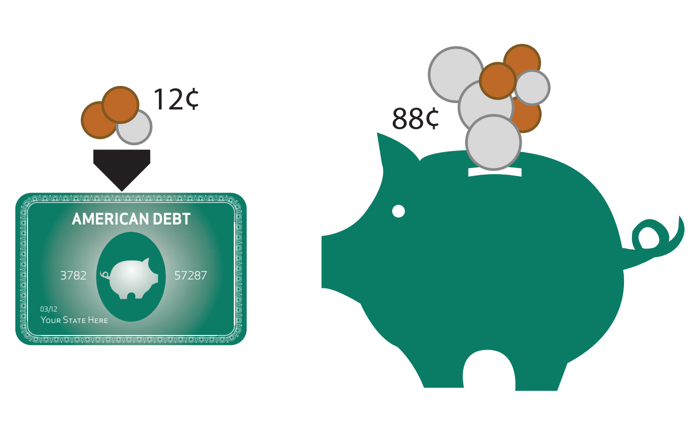
Another way of saying this is that employers contribute just about 21 cents of every dollar of total pension fund receipts. Employees contribute another 11 cents, and the rest—a full 68 cents on the dollar—is made up of investment earnings.

The Importance of Making Contributions on Time and In Full

Normal Cost **Payments on any Unfunded Liabilty**

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, about 88% of the ARC was received by the largest state and local retirement systems in the country in 2008. Most funds (about 6 in 10) received payment for the full amount of their ARC or something close to it in 2008.[6]

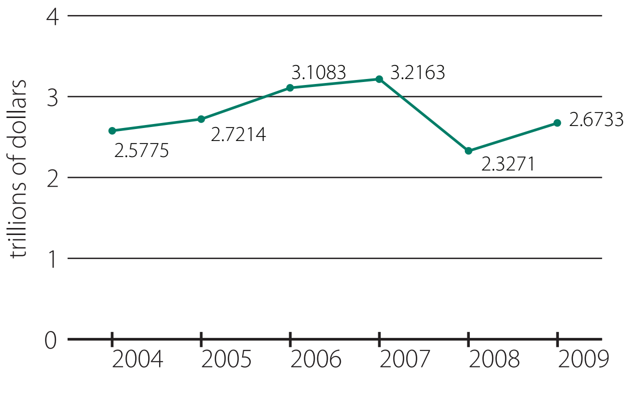
Unfortunately, in the past several years, other states and cities have failed to keep up with their required pension contributions, and are now finding that the consequences of that delay are now catching up to them in the form of much higher required pension contributions. In other words, that accrued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

The Economic Downturn Will Cause 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 of 2008 and 2009 included unprecedented losses in the stock market. Because public pension funds are invested in the market, 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 the end of 2009, the value of public pension assets had recovered to about $2.7 trillion—however, this is still about 17% below the highs reached in 2007.[7]

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



Clearly, state and local pension funds took a big hit. And as a result, most funds will require 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 will be manageable for most states.

Researchers at Boston College estimate that on average, states can pay off the entire funding gap in 30 years if they increase contributions to their pension funds by 2.2% of payrolls.[8] And if employees and employers equally share the increase, then the employer contribution (i.e. the portion funded by taxpayers) would only have to increase by 1.1% of payroll. (To put this in context, most states have historically contributed about 10% of payroll in total to fund pensions.)

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. These states will likely see contributions growing much faster than just one or two percent of payroll. Finding the money for these additional contributions will be tough, considering the budget crunch most governments are facing. 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 to taxpayers too.

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 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.

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[7] Board of Governors, Federal Reserve System. 2010. *Flow of Funds Accounts of the United States.* Washington, DC: Board of Governors.

[8] Munnell, A.H., Aubry, J., and Quinby, L. 2010. *The Funding of State and Local Pensions: 2009-2013.* Chestnut Hill, MA: The 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.