RIPEC

# Comments on Your Government

A SPECIAL PUBLICATION OF THE RHODE ISLAND PUBLIC EXPENDITURE COUNCIL

## Local Government Pensions

This RIPEC *Comments* is intended to provide a summary of local government's current pension system, and to develop strategies to curb future costs to taxpayers while providing appropriate benefits to municipal government's workforce. This report is the second in a series of reports on pensions and health care costs. The first report provided an analysis of Rhode Island's State pension system and in the upcoming weeks, RIPEC will release a report that reviews the issues related to retiree health care costs and alternatives to begin addressing an estimated unfunded retiree health care liability in excess of $480 million. All the reports can be accessed on RIPEC's website at www.ripec.org.

The report does not include an analysis of the impact of the current economic crisis on the stock and bond markets and the resultant reductions in the asset value of state and local pension systems. These declines in value will further reduce the funding levels contained in this report. The actuarial report is expected to be released soon and will include new liability and funding requirements.

***Background***

Between 1991 and 2005, employee retirement and health care costs throughout the country have risen faster than wages. Indeed, the cost of health and retirement benefits increased by 34.0 percent compared to 10.0 percent in wage growth.[i] This has served as a catalyst for employers to seek out cost-control strategies to remain competitive and efficient.

The national economic recession, combined with the crisis in the financial sector, has had an additional impact on the fiscal health of municipal pension systems. If the stock and bond markets do not rebound quickly and the recession continues, local leaders will be faced with difficult choices to shore up pension funds that have lost a large amount of value in recent months.

State and local governments are facing similar financial stresses, and health care and retirement costs represent significant budget drivers. Benefit costs represent approximately 26 percent of municipal government's general revenue budget in FY 2009. Given this, there has been increased attention on the variables driving personnel costs. The Governor's FY 2009 Supplemental Budget also proposed significant pension changes affecting local government, which are summarized in this analysis.

**May 2009**

*Summary of key findings*

Currently the State of Rhode Island administers the Municipal Employees Retirement System (MERS) for approximately 110 municipal pension plans for general employees, police and fire, for about 30 municipal governments whereas about 37 pension plans are locally-administered by 25 communities.

Municipal Pension Contributions (including MERS and locally-administered plans)

- Municipal budgets allocate nearly $149.0 million in pension costs in FY 2009, up from $101.5 million in FY 2004, or 46.7 percent during that time frame.
- As a percentage of their operating budgets (excluding education costs) local governments fund 10.8 percent of their budgets to cover pension costs in FY 2009, whereas in FY 2004 these costs accounted for 9.2 percent of the general fund budget.
- The local pension payment as a percent of the municipal operating budget is higher than the State's pension payment in FY 2009 (7.0 percent of the State operating budget).
- In FY 2009, pension contributions for municipal employees only (excluding public safety employees) amounted to $29.6 million, or 2.2 percent of general fund expenditures. Pension contributions for public safety employees (police and fire) amounted to $111.4 million, or 8.1 percent of general fund expenditures.
- On a per employee basis, average pension costs amounted to $16,207 per local government employee in FY 2009. Pension costs per employee amounted to $6,579 for a municipal employee, $21,377 for a police employee, and $26,901 for a firefighter in FY 2009. As a comparison, pension costs, on average, amounted to $10,638 per State employee in the FY 2009 budget.

Comparison MERS to Locally-Administered Pension Plans

- The estimated funding ratio for MERS is 90.3 percent as of June 30, 2007, the most recent actuarial valuation date. The locally administered pension plans had an estimated collective funding ratio of 45.0 percent as of June 30, 2006.

**Rhode Island's Local Government Pensions**
**Summary Data ($ million)**

| | MERS | Locally-Admin. Plans Plans** |
|---|---|---|
| Assets | $1,064.6 | $1,287.1 |
| Liabilities | $1,179.2 | $2,860.4 |
| Unfunded Liability | $114.6 | $1,573.3 |
| Aggregate Funding Ratio | 90.3% | 45.0% |

*Municipal Employees' Retirement System (MERS): Data are from ERSRI, June 30, 2008
** Based on Auditor General's report "Status of Pension Plans Administered by RI Municipalities, July 2007

- MERS has an unfunded liability of $114.6 million (June 30, 2007) and locally administered plans an unfunded liability of $1.6 billion (June 30, 2006).

Comparison MERS to State Employees' Retirement System

- Assuming a final average salary of $56,000 and 25 years of service, general employees covered under MERS will receive a pension of $28,000, compared to $35,000 for police and fire employees in the MERS system. State employees in Schedule A will receive $28,560 while State employees in Schedule B receive $24,640.

**Pension Comparison**
**Final Average Salary: $56,000**

| | MERS | | State Employees | |
|---|---|---|---|---|
| **Years of Service** | **Gen Employee** | **Police/Fire** | **Schedule A** | **Schedule B** |
| 25 years | $28,000 | $35,000 | $28,560 | $24,640 |
| 30 years | $33,600 | $42,000 | $36,960 | $30,940 |

Source: ERS and RIPEC calculations.

***Overview of Proposed Pension Changes***

Governor Carcieri proposed several reforms to the current pension system for State, teachers and municipal employees in his FY 2009 Supplemental Budget and they are still before the General Assembly. The proposed changes impacting local governments include: reductions to the disability pension benefits where the employee is not totally disabled; minimum retirement ages on non-vested municipal employees, including police and firefighters; and application of all age, years of service, and contribution rates established under the Municipal Employees' Retirement System (MERS) to all municipally administered pension plans. Specifically, the proposal includes:

- After July 1, 2009, municipal employees who are not yet vested as of July 1, 2009, in the retirement system will be eligible to retire at age 59 with 29 years of service, or at age 65 with 10 years of service, or at age 55 with 20 years of service at an actuarially reduced pension. In addition, municipal police and firefighters who are not vested and retire after July 1, 2009 must be 55 years of age to be eligible to receive a pension, or actuarial reduction;
- Changes the maximum benefit and establishes reporting criteria for municipal employees, police and firefighters who retire on accidental disability after July 1, 2009;
- Increases the employee contribution rate for MERS plans from 6 percent to 7 percent, and increasing the police and firefighter employee contribution rate from 7 percent to 8 percent as of July 1, 2009;

- Applies the MERS age, years of service, and contribution rates established under MERS to all municipally administered pension plans; and
- Reduces the funding requirement for the Teacher Retirement System to 25.0 percent of the actuarial rate from April 1 to June 30.

To address the economic downturn and the risks for pension funds associated with it, as well as the growing amount State and local governments contribute to pensions, RIPEC recommends that municipal governments continue to seek alternative ways to reduce costs and minimize risk. This is a necessary step to begin to control the rate of growth of pension costs and to reduce the unfunded liability.

To reduce risk, control the rate of growth in pension expenditures, and to improve the local funding status RIPEC recommends that local governments undertake a review of the current pension system funding and structure. Similar to the House of Representatives study committee on pensions, municipal governments need to review the current pension system and, where necessary, seek General Assembly approval of pension changes. For those who are not part of the State Municipal Employees' Retirement System (MERS) municipalities should seriously consider merging their self-administered plans into the MERS. Any mergers will not happen quickly, however, they can be phased-in over time to address local needs and capabilities

The following report is divided into five sections:

**Municipal Budgets and Pension Costs** – Analyzing total pension costs for municipal employees, police and fire, as well as per employee costs, using data from the Rhode Island Office of Municipal Affairs;

**Municipal Employee Pensions Overview** – Analyzing data for the State-administered Municipal Employee Retirement System (MERS), and comparing MERS with the State Employees Retirement System, based on the Employees' Retirement System of Rhode Island Actuarial Valuation.

**Locally Administered Plans** – Analyzing data for locally administered plans, based on the Auditor General's report from July 2007.

**Characteristics of Pension Plans** – Providing an overview of state and local pension systems in the nation; and

**Definition and Overview of Terms**

## Municipal Budgets and Pension Costs

This section analyzes pension costs for municipal employees, police and fire, as well as per employee costs, using data compiled by the Rhode Island Division of Municipal Affairs. Data include the general fund budget (excluding education costs), and show municipal pension costs for locally administered pensions as well as pension costs for the State-administered Municipal Employee Retirement System (MERS). Based on these data, local governments in Rhode Island funded pension cost of $101.5 million in FY 2004. This amount increased to $148.9 million in FY 2009. This reflects an increase of 46.7 percent over the five-year period, or an average annual growth of 8.0 percent. The pension payments represent 9.2 percent of the total municipal budget exclusive of education in FY 2004, and increased to 10.8 percent in FY 2009.

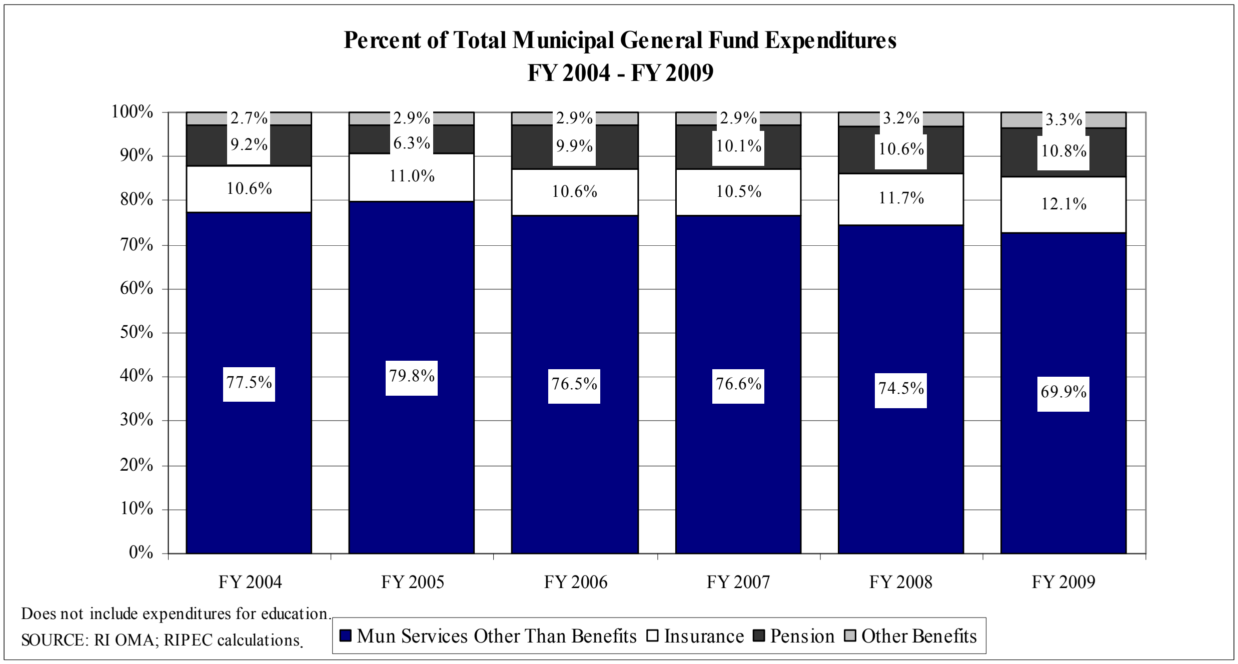
**Public Pensions as a Percent of Municipal General Fund Expenditure Budgets**
**FY 2004 - FY 2009**

| | FY 2004 | | | FY 2009 | | | FY 2004 - 09 | |
|---|---|---|---|---|---|---|---|---|
| CITY/TOWN | Municipal Services | Pension* | Pension % of Budget | Municipal Services | Pension* | Pension % of Budget | Municipal Services | Pension* |
| BARRINGTON | $15,906,551 | $275,000 | 1.7% | $17,690,693 | $854,909 | 4.8% | 11.2% | 210.9% |
| BRISTOL | 16,908,144 | 300,001 | 1.8% | 24,893,367 | 1,441,915 | 5.8% | 47.2% | 380.6% |
| BURRILLVILLE | 16,844,958 | 224,125 | 1.3% | 19,283,589 | 385,300 | 2.0% | 14.5% | 71.9% |
| CENTRAL FALLS | 15,250,215 | 1,621,763 | 10.6% | 17,486,368 | 2,182,664 | 12.5% | 14.7% | 34.6% |
| CHARLESTOWN | 7,149,506 | 228,599 | 3.2% | 9,900,752 | 500,000 | 5.1% | 38.5% | 118.7% |
| COVENTRY | 17,401,785 | 1,550,000 | 8.9% | 22,390,992 | 2,838,733 | 12.7% | 28.7% | 83.1% |
| CRANSTON | 91,950,993 | 22,136,170 | 24.1% | 104,540,642 | 22,284,235 | 21.3% | 13.7% | 0.7% |
| CUMBERLAND | 18,713,837 | 782,672 | 4.2% | 24,134,262 | 1,589,946 | 6.6% | 29.0% | 103.1% |
| EAST GREENWICH | 10,805,712 | 20,604 | 0.2% | 15,123,461 | 525,016 | 3.5% | 40.0% | 2448.1% |
| EAST PROVIDENCE | 42,733,776 | 1,519,978 | 3.6% | 52,652,503 | 3,603,862 | 6.8% | 23.2% | 137.1% |
| EXETER | 2,113,070 | 0 | 0.0% | 2,449,386 | 21,882 | 0.9% | 15.9% | - |
| FOSTER | 3,343,065 | 22,146 | 0.7% | 4,720,238 | 151,236 | 3.2% | 41.2% | 582.9% |
| GLOCESTER | 6,479,291 | 147,605 | 2.3% | 8,068,469 | 350,146 | 4.3% | 24.5% | 137.2% |
| HOPKINTON | 4,956,651 | 48,000 | 1.0% | 5,780,143 | 282,277 | 4.9% | 16.6% | 488.1% |
| JAMESTOWN | 5,958,643 | 194,631 | 3.3% | 8,466,312 | 376,352 | 4.4% | 42.1% | 93.4% |
| JOHNSTON | 34,726,314 | 1,114,047 | 3.2% | 45,384,453 | 6,711,452 | 14.8% | 30.7% | 502.4% |
| LINCOLN | 17,150,516 | 329,400 | 1.9% | 23,519,765 | 573,713 | 2.4% | 37.1% | 74.2% |
| LITTLE COMPTON | 3,649,433 | 207,000 | 5.7% | 4,648,170 | 338,040 | 7.3% | 27.4% | 63.3% |
| MIDDLETOWN | 17,733,861 | 2,118,854 | 11.9% | 26,907,929 | 3,025,643 | 11.2% | 51.7% | 42.8% |
| NARRAGANSETT | 14,754,329 | 631,229 | 4.3% | 22,931,244 | 998,719 | 4.4% | 55.4% | 58.2% |
| NEWPORT | 46,908,721 | 7,007,158 | 14.9% | 53,540,851 | 6,867,173 | 12.8% | 14.1% | -2.0% |
| NEW SHOREHAM | 4,482,573 | 75,803 | 1.7% | 6,640,272 | 176,535 | 2.7% | 48.1% | 132.9% |
| NORTH KINGSTOWN | 27,529,243 | 599,153 | 2.2% | 31,904,698 | 1,911,981 | 6.0% | 15.9% | 219.1% |
| NORTH PROVIDENCE | 29,372,713 | 982,499 | 3.3% | 37,034,149 | 2,300,000 | 6.2% | 26.1% | 134.1% |
| NORTH SMITHFIELD | 8,963,338 | 85,785 | 1.0% | 12,890,919 | 222,432 | 1.7% | 43.8% | 159.3% |
| PAWTUCKET | 64,797,159 | 3,635,000 | 5.6% | 108,498,397 | 7,073,736 | 6.5% | 67.4% | 94.6% |
| PORTSMOUTH | 15,547,743 | 960,919 | 6.2% | 19,468,259 | 1,946,014 | 10.0% | 25.2% | 102.5% |
| PROVIDENCE | 265,945,022 | 33,795,648 | 12.7% | 318,469,356 | 47,477,759 | 14.9% | 19.8% | 40.5% |
| RICHMOND | 3,042,729 | 13,420 | 0.4% | 4,002,881 | 112,000 | 2.8% | 31.6% | 734.6% |
| SCITUATE | 7,865,068 | 373,220 | 4.7% | 10,322,098 | 648,221 | 6.3% | 31.2% | 73.7% |
| SMITHFIELD | 23,046,820 | 1,869,040 | 8.1% | 29,205,339 | 2,226,000 | 7.6% | 26.7% | 19.1% |
| SOUTH KINGSTOWN | 17,949,241 | 102,439 | 0.6% | 26,334,596 | 914,586 | 3.5% | 46.7% | 792.8% |
| TIVERTON | 10,613,670 | 526,242 | 5.0% | 16,397,109 | 781,322 | 4.8% | 54.5% | 48.5% |
| WARREN | 9,060,986 | 290,000 | 3.2% | 11,549,987 | 610,000 | 5.3% | 27.5% | 110.3% |
| WARWICK | 103,445,502 | 13,509,305 | 13.1% | 117,586,450 | 20,323,512 | 17.3% | 13.7% | 50.4% |
| WESTERLY | 19,471,612 | 1,553,666 | 8.0% | 27,003,855 | 1,864,147 | 6.9% | 38.7% | 20.0% |
| WEST GREENWICH | 4,083,812 | 86,775 | 2.1% | 5,746,078 | 256,450 | 4.5% | 40.7% | 195.5% |
| WEST WARWICK | 30,822,189 | 1,535,050 | 5.0% | 30,243,950 | 2,219,825 | 7.3% | -1.9% | 44.6% |
| WOONSOCKET | 41,454,161 | 994,107 | 2.4% | 50,891,693 | 1,909,808 | 3.8% | 22.8% | 92.1% |
| **TOTAL** | **$1,098,932,952** | **$101,467,053** | **9.2%** | **$1,378,703,675** | **$148,877,541** | **10.8%** | **25.5%** | **46.7%** |

* Pension totals do not include municipal contributions to education pension benefits.

SOURCE: Rhode Island Office of Municipal Affairs, various years; RIPEC calculations

The local pension payment, as a percent of the municipal operating budget, is higher than the State's share of pension costs (7.0 percent of the state operating budget in FY 2009). Among the communities, the pension costs as a percent of the general fund budget range from a low of 0.9 percent in Exeter to a high of 21.3 percent in Cranston.




This chart shows the increasing amount pension costs take up of municipal general fund budgets. Insurance costs (medical and dental insurance for active employees and retirees) as a percent of the general revenue budget also increased during that time period. In FY 2004, these expenses accounted for 10.6 percent of general fund expenses for municipalities which in FY 2009 they accounted for 12.1 percent of total municipal general fund spending.

The table to the right shows FY 2009 community pension contributions for municipal employees, police, fire and other pensions; as well as pension costs by employee. In FY 2009, pension contributions for municipal employees amounted to $29.6 million, or 2.2 percent of general fund expenditures. Pension contributions for public safety employees (police and fire) totaled $111.4 million, or 8.1 percent of general fund expenditures.

**Municipal Pension Contributions and Pension Cost Per Employee FY 2009**

| | Pension Contribution* Total Amount | Per Employee** |
|---|---|---|
| Municipal | $29,642,180 | $6,579 |
| Police | 56,179,769 | 21,377 |
| Fire | 55,201,304 | 26,901 |
| **Total*** ** | **$148,877,541** | **$16,207** |

*Pension contributions do not include contributions to education pension benefits.
**FTE personnel cound only includes positions funded by general fund budget.
***Includes $7.9 million in other pension contr.
Source: Division of Municipal Affairs, and RIPEC calculations.

On a per employee basis, average pension costs for all municipal employees accounted for $16,207 in FY 2009. Pension costs per employee amounted to $6,579 for a municipal employee, $21,377 for a police employee, and $26,901 for a firefighter in FY 2009. As a comparison, pension costs for a State employee amounted to $10,638 in the FY 2009 budget.

## Municipal Employee Pensions Overview

Municipal employees under the State-administered Municipal Employee Retirement System (MERS) receive 2.0 percent per year of service times the final average salary. The plan covers various categories of municipal employees, such as general, police and fire, and had approximately $1.1 billion in assets as of June 30, 2007. The estimated accrued net unfunded liability of $114.6 million translates to a funded ratio of 90.3 percent. It should be noted that the system had a funded ratio of over 100 percent until 2004. In fact, ten years ago, the fund was 130 percent funded. Municipalities participating in the MERS system have made 100 percent of their required contributions.

*All Rhode Island communities participate in the teacher retirement pension fund, and continue to make their required contributions. The Employees' Retirement System of Rhode Island for Teachers, again administered by the State, covers all local public school teachers and has an estimated $3.8 billion in assets. However, there is an estimated $2.6 billion in estimated net unfunded liabilities, thereby resulting in an estimated funding ratio of 55.4 percent. Note that the teacher contribution is 9.5 percent of salary.*

When comparing the benefit structure of MERS with Schedule A and B for State employees (ERSRI), one can see that there are some differences in the provisions for the retirement age, formula calculation, and the Cost of Living Adjustment (COLA) (see table on page 8). Generally speaking, MERS allows retirement at an earlier age for people who have at least 10 years of service. Under MERS, general employees can retire at age 58 with 10 years of service, or at any time with 30 years of service. Police and fire employees can retire at age 55 with 10 years of service or at any time with 25 years of service. One should note that most police and fire pension plans have adopted the 20-year provision, where employees can retire at any age after 20 years of service. Under Schedule A of ERSRI, employees can retire at age 60 with 10 years of service or at any time with 28 years of service. Schedule B allows for retirement at age 65 with 10 years of service, or at age 59 with 29 years of service.

### *Rhode Island MERS Pension Calculations*

There are several categories of employees that receive different types of pension benefits once the retirement requirements are met. On the local level, employees receive various benefits as determined by the MERS plan. Individual units may elect certain optional provisions, including an annual benefit increase of 3 percent of the original benefit amount applicable to future retirees only, the same increase applicable to both current and future retirees, or the 20-year retirement provision for police/fire units. For regular employees and for police and fire there are two distinct plans for each. Each category of employee has different calculations for retirement benefits, different contribution rates by both the employee and the municipality, and different retirement benefit eligibility requirements which will be discussed below. The following outlines how Rhode Island calculates the pension benefit for a typical local government employee in MERS. There are four plans depending on whether one is covered as a regular employee or a police or fire department employee.

| | Municipal Employees' Retirement System | | | | Employees' Retirement System of Rhode Island | |
|---|---|---|---|---|---|---|
| | General Employee | General Employee With COLA | Police/Fire | Police/Fire With Options ** | Schedule A | Schedule B |
| Employer Contribution | 6% | 6% | 7% | 7% | | |
| Optional COLA | | 1% | | 1% | | |
| Optional 20 year Police/Fire | | | | 1% | | |
| Total | 6% | 7% | 7% | 9% | 8.75% | 8.50% |
| Social Security Coverage | | | Depends*** | Depends*** | Yes | Yes |
| Vesting Requirements | 10 Years | | 10 Years | | 10 Years | 10 Years |
| Average Final Compensation | High 3 consec yrs. | | High 3 consec yrs | High 3 consec yrs | High 3 consec yrs | High 3 consec yrs |
| Normal Retirement Age* | 58/10; 00/30 | | 55/10; 00/25 | 55/10; 00/20 | 60/10; 00/28 | 65/10; 59/29 |
| Formula Calculation | | | | | | |
| -Years 1-10 | 2.00% | 2.00% | 2.00% | 2.50% | 1.70% | 1.60% |
| -Years 11-20 | 2.00% | 2.00% | 2.00% | 2.50% | 1.90% | 1.80% |
| -Years 21-25 | 2.00% | 2.00% | 2.00% | 2.50% | 3.00% | 2.00% |
| -Years 26-30 | 2.00% | 2.00% | 2.00% | 2.50% | 3.00% | 2.25% |
| -Years 31-34 | 2.00% | 2.00% | 2.00% | 2.50% | 3.00% | 2.50% |
| -Years 35 | 2.00% | 2.00% | 2.00% | | 2.00% | 2.50% |
| -Years 36-37 | 2.00% | 2.00% | 2.00% | | | 2.50% |
| -Years 38 | 2.00% | 2.00% | 2.00% | | | 2.25% |
| Maximum Benefit | 75.00% | 75.00% | 75.00% | 75.00% | 80.00% | 75.00% |
| Early Retirement option | None | None | Yes**** | | None | 55/20 |
| Formula Calculation | | | .5% per month reduction | | | Actuarial |
| COLA | 0.0% | 3.0% | 0.0% | 3.0% | 3% Fixed | 100% of CPI. Max. which ever is lower |

Several communities (Burrillville Police, South Kingstown Police, Hopkinton Police, Cranston Fire, Cranston Police, Richmond Police) have enacted specific legislation with specific benefits beyond the terms listed.

*For MERS only: Members may retire with reduced benefits if they are at least 50 and have at least 20 years of service.

** Individual units may elect certain optional provisions, including an annual benefit increase of 3% of the original benefit amount applicable to future retirees only, the same increase applicable to both current and future retirees, or the 20-year retirement provision to retire at any age after 20 years of service.

One should note that most police/fire pension plans have adopted the 20-year retirement provision and a 3% annual increase.

***Some communities have opted out and others may not.

****Those not covered by the 20-year option retirees between age 55 with 20 years but less than 25, benefits are reduced 0.5% per month that the members' age is less than 55.

Source: Employees' Retirement System of Rhode Island Actuarial Valuation

Because the methods are similar but the variables applied differ in calculating retirement benefits, the following outlines the methodology and an example of how the retirement benefit would differ under the four schedules with an employee who has various years of service with an average final compensation of $56,000

## Benefit Calculations

*Schedule A – Employees*

Regular MERS employees, municipal police and fire, state employees covered by Schedule A and Schedule B can be eligible to collect benefits at various stages. Some have to work to age 60 or at any age as long as they have at least a certain amount of years of service. The maximum benefit for an employee is 80 percent for Schedule A employees and 75 percent for MERS municipal employees, regardless of the number of years served. The methodology for calculating the actual pension follows the following course.

- *Step 1* – Calculate the average final compensation (AFC), which is based on the highest three consecutive annual salaries (all examined employees).
- *Step 2* – Use the formula based on a certain percentage multiplied by the employee's total number of years of service. Rhode Island does not have a single multiplier. Rather, there is a graduated multiplier depending on the number of years served. Rhode Island applies 1.7 percent to each of the first ten years of service, 1.9 percent for each of the next ten years of service and 3.0 percent per year for the next 14 years, and 2.0 percent for the 35th year. Municipal employees have a straight percentage applied for all years of services.
- *Step 3* – Apply these factors to the AFC.

**Schedule A**
**Rhode Island Pension Benefit**
**Employee With 30 Years of Service**

| | | | Teacher | State |
|---|---|---|---|---|
| **Average Final Compensation:** | | | **$70,000** | **$56,000** |
| **Pension Calculation** | **Factor** | **Years** | **Benefit** | **Benefit** |
| - First 10 Years | 1.70% | 10 | $11,900 | $9,520 |
| - Second 10 Years | 1.90% | 10 | 13,300 | 10,640 |
| - Third Ten Years | 3.00% | 10 | 21,000 | 16,800 |
| **Estimated Total Benefit** | | | **$46,200** | **$36,960** |
| Percent of AFC: | | | 66.0% | 66.0% |

For example, under Schedule A, a Rhode Island State employee with 30 years of service and an average final compensation of $56,000 would receive estimated benefits of $36,960, which would be approximately 66 percent of the retiree's average final compensation. As one can see from the calculation, Schedule A was designed as a "back-loaded" program, where nearly 50 percent of the benefit was earned in the last ten years of service. An individual's entire pension is taxable in Rhode Island.

*Schedule B (State Employees Hired After July 1, 2005 or who had less than 10 years of service as of July 1, 2005)*
Schedule B applies to those employees hired after July 1, 2005 or who had less than 10 years of service as of July 1, 2005 (approximately 3,500 employees). An eligible employee can collect benefits at age 59 with 29 years of service or at age 65 with 10 years of service. The maximum benefit for an employee is 75 percent, regardless of the number of years served. Employees may retire at age 55 with 20 years of service as well. There is a cost of living provision for those who retire, providing 100 percent of the CPI or 3.0 percent, whichever is less, with an initial delay for the COLA of 3 years.

The same employee used in the first scenario would have a different pension benefit under Schedule B. Again, based on an assumption that the Rhode Island State employee would have 30 years of service with an average final compensation of $56,000, the employee would receive estimated benefits of $30,940, which would be 55.3 percent of the retiree's average final compensation. As one can see from this calculation, Schedule B is no longer as heavily "back-loaded" as Schedule A. In fact, given these assumptions, the pension benefit earned by the employee under Schedule B would be 83.7 percent of the value of the pension under Schedule A.

**Schedule B**
**Rhode Island Pension Benefit**
**Employee With 30 Years of Service**

| | | | Teacher | State |
|---|---|---|---|---|
| **Average Final Compensation:** | | | **$70,000** | **$56,000** |
| **Pension Calculation** | **Factor** | **Years** | **Benefit** | **Benefit** |
| - First 10 Years | 1.60% | 10 | $11,200 | $8,960 |
| - Second 10 Years | 1.80% | 10 | 12,600 | 10,080 |
| - Next Five Years | 2.00% | 5 | 7,000 | 5,600 |
| - Next Five Years | 2.25% | 5 | 7,875 | 6,300 |
| **Estimated Total Benefit** | | | **$38,675** | **$30,940** |
| Percent of AFC: | | | 55.3% | 55.3% |
| *Percent of Schedule A:* | | | *83.7%* | *83.7%* |

Using the same methodology, but with the benefits afforded to employees within the MERS system, the same calculation has been made for an employee retiring with 25 years, 30 years and 35 years of service for municipal employees and 25 years and 30 years for Police and fire.

The following illustrates a comparison of the Schedule A and Schedule B State employee, a regular employee in MERS and a member of the police/fire MERS system.

Due to the back loading of the state system, municipal employee fare as well as schedule A employees until more years are accumulated.

It should be noted that many police and fire departments in the state are not part of social security.

## Comparison MERS - ERS

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Years of Service** | **25 years** | | | | | | |
| **Average Salary** | **$56,000** | | | | **$56,000** | | |
| | MERS | | | | ERS | | |
| | **Gen. Empl.** | | | **Schedule A** | | **ScheduleB** | |
| -Years 1-10 | 10 | 2.00% | | 1.70% | 17.00% | 1.60% | 16.00% |
| -Years 11-20 | 10 | 2.00% | | 1.90% | 19.00% | 1.80% | 18.00% |
| -Years 21-25 | 5 | 2.00% | | 3.00% | 15.00% | 2.00% | 10.00% |
| -Years 26-30 | | 2.00% | | 3.00% | | 2.25% | |
| -Years 31-34 | | | | 3.00% | | 2.50% | |
| -Years 35 | | | | 2.00% | | 2.50% | |
| -Years 36-37 | | | | | | | |
| | 25 | 2.00% | 50.00% | | 51.00% | | 44.00% |
| | | | **$28,000** | | **$28,560** | | **$24,640** |
| AFC | | | **50.00%** | | **51.00%** | | **44.00%** |
| **Years of Service** | **30 years** | | | | | | |
| **Average Salary** | **$56,000** | | | | **$56,000** | | |
| | **Gen. Empl.** | | | **Schedule A** | | **ScheduleB** | |
| -Years 1-10 | 10 | 2.00% | | 1.70% | 17.00% | 1.60% | 16.00% |
| -Years 11-20 | 10 | 2.00% | | 1.90% | 19.00% | 1.80% | 18.00% |
| -Years 21-25 | 5 | 2.00% | | 3.00% | 15.00% | 2.00% | 10.00% |
| -Years 26-30 | 5 | 2.00% | | 3.00% | 15.00% | 2.00% | 11.25% |
| -Years 31-34 | | 2.00% | | 3.00% | | 2.50% | |
| -Years 35 | | 2.00% | | 2.00% | | 2.50% | |
| -Years 36-37 | | | | | | | |
| | 30 | 2.00% | 60.00% | | 66.00% | | 55.25% |
| | | | **$33,600** | | **$36,960** | | **$30,940** |
| AFC | | | **60.00%** | | **66.00%** | | **55.25%** |
| **Years of Service** | **35 years** | | | | | | |
| **Average Salary** | **$56,000** | | | | **$56,000** | | |
| | **Gen. Empl.** | | | **Schedule A** | | **ScheduleB** | |
| -Years 1-10 | 10 | 2.00% | | 1.70% | 17.00% | 1.60% | 16.00% |
| -Years 11-20 | 10 | 2.00% | | 1.90% | 19.00% | 1.80% | 18.00% |
| -Years 21-25 | 5 | 2.00% | | 3.00% | 15.00% | 2.00% | 10.00% |
| -Years 26-30 | 5 | 2.00% | | 3.00% | 15.00% | 2.25% | 11.25% |
| -Years 31-34 | 5 | 2.00% | | 3.00% | 15.00% | 2.50% | 12.50% |
| -Years 35 | | | | 2.00% | | 2.50% | |
| -Years 36-37 | | | | | | | |
| | 35 | 2.00% | 70.00% | | 81.00% | | 67.75% |
| | | | **$39,200** | | **$45,360** | | **$37,940** |
| AFC | | | **70.00%** | | **81.00%** | | **67.75%** |

## Comparison MERS - ERS

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Years of Service** | **25 years** | | | | | | |
| **Average Salary** | **$56,000** | | | | **$56,000** | | |
| | MERS | | | ERS | | | |
| | **Police/Fire** | | | **ScheduleA** | | **ScheduleB** | |
| -Years 1-10 | 10 | 2.50% | | 1.70% | 17.00% | 1.60% | 16.00% |
| -Years 11-20 | 10 | 2.50% | | 1.90% | 19.00% | 1.80% | 18.00% |
| -Years 21-25 | 5 | 2.50% | | 3.00% | 15.00% | 2.00% | 10.00% |
| -Years 26-30 | | | | 3.00% | | 2.25% | |
| -Years 31-34 | | | | 3.00% | | 2.50% | |
| -Years 35 | | | | 2.00% | | 2.50% | |
| -Years 36-37 | | | | | | | |
| | 25 | 2.50% | 62.50% | | 51.00% | | 44.00% |
| | | | **$35,000** | | **$28,560** | | **$24,640** |
| AFC | | | **62.50%** | | **51.00%** | | **44.00%** |
| **Years of Service** | **30 years** | | | | | | |
| **Average Salary** | **$56,000** | | | | **$56,000** | | |
| | **Police/Fire** | | | **Schedule A** | | **Schedule B** | |
| -Years 1-10 | 10 | 2.50% | | 1.70% | 17.00% | 1.60% | 16.00% |
| -Years 11-20 | 10 | 2.50% | | 1.90% | 19.00% | 1.80% | 18.00% |
| -Years 21-25 | 5 | 2.50% | | 3.00% | 15.00% | 2.00% | 10.00% |
| -Years 26-30 | 5 | 2.50% | | 3.00% | 15.00% | 2.25% | 11.25% |
| -Years 31-34 | | | | 3.00% | | 2.50% | |
| -Years 35 | | | | 2.00% | | 2.50% | |
| -Years 36-37 | | | | | | | |
| | 30 | 2.50% | 75.00% | | 66.00% | | 55.25% |
| | | | **$42,000** | | **$36,960** | | **$30,940** |
| AFC | | | **75.00%** | | **66.00%** | | **55.25%** |

As an example, under the MERS schedule, a municipal employee with 30 years of service and an average final compensation of $56,000 would receive estimated benefits of $33,600, approximately 60 percent of the retiree's average final compensation. The entire pension is taxable in Rhode Island.

As an another example, under the MERS schedule, a police or fire employee with 30 years of service and an average final compensation of $56,000 would receive estimated benefits of $42,000, or approximately 75 percent of the retiree's average final compensation. As with municipal employees, the entire pension is taxable in Rhode Island.

## Locally Administered Plans

Based on the Auditor General's July 2007 report, *Status of Pension Plans Administered by Rhode Island Municipalities*, there are 37 pension plans administered by the 25 Rhode Island communities that do not participate in MERS, and operate their own pension systems, which are often referred to as self-administered plans. These plans hold nearly $1.3 billion in assets (June 30, 2006), with a liability of $2.9 billion, resulting in $1.6 billion unfunded liability of accrued benefits collectively. This translates into an estimated collective funding ratio of 45 percent.[ii] While the calculations for the benefits differ among these communities, most have one thing in common – they all have funded ratios well below the MERS system.

**Rhode Island Municipal Pension Plans**
**Unfunded Actuarial Accrued Liability (UAAL)**

| Municipality | Plan | Funding Ratio | Rank | Actuarial Assets | Liabilities | Unfunded | Valuation Date |
|---|---|---|---|---|---|---|---|
| Bristol | Police Pension Plan (Prior to 3/22/98) | 67.4% | 15 | $11,575,785 | $17,184,668 | $5,608,883 | 6/30/2006 |
| Central Falls | Police and Fire (after 71/72) John Hancock | 34.6% | 28 | 10,909,756 | 31,509,376 | 20,599,620 | 7/1/2006 |
| | Police and fire (before 7/1/72) 1% | 7.3% | 35 | 1,146,741 | 15,738,443 | 14,591,702 | 7/1/2006 |
| Coventry | Municipal EE Retirement Plan | 18.0% | 32 | 2,491,657 | 13,834,699 | 11,343,042 | 1/1/2006 |
| | Police Pension Plan | 7.9% | 34 | 3,875,285 | 49,041,156 | 45,165,871 | 1/1/2006 |
| | School EES Pension Plan | 46.6% | 21 | 8,176,178 | 17,544,846 | 9,368,668 | 9/1/2004 |
| Cranston | Police and Fire (Pre 7/1/95) | 15.5% | 33 | 39,931,111 | 257,474,713 | 217,543,602 | 7/1/2006 |
| Cumberland | Town of Cumberland's Pension Plan | 59.5% | 18 | 9,288,610 | 15,617,633 | 6,329,023 | 7/1/2005 |
| East Providence | Firemen's and Policemen's Pension Plan | 69.9% | 13 | 73,760,000 | 105,480,000 | 31,720,000 | 10/31/2006 |
| Jamestown | Police Pension Plan | 123.9% | 2 | 6,745,427 | 5,442,622 | (1,302,805) | 3/1/2004 |
| Johnston | Police | 30.8% | 29 | 11,455,511 | 37,167,194 | 25,711,683 | 6/30/2005 |
| | Fire (prior to 7/1/99) | 30.7% | 30 | 13,549,265 | 44,078,961 | 30,529,696 | 6/30/2005 |
| Lincoln | Town Retirement Plan | 90.9% | 5 | 15,730,030 | 17,296,311 | 1,566,281 | 1/1/2006 |
| Little Compton | Town Employees Other than Teachers | 80.4% | 9 | 4,732,930 | 5,883,241 | 1,150,311 | 7/1/2005 |
| Middletown | Town Plan | 72.2% | 12 | 7,926,793 | 10,974,290 | 3,047,497 | 6/30/2005 |
| Narragansett | Police Plan (prior to 7/1/78) | 5.1% | 36 | 48,555 | 949,819 | 901,264 | 7/1/2005 |
| | Town Plan | 79.0% | 10 | 41,278,370 | 52,236,039 | 10,957,669 | 7/1/2005 |
| Newport | Firemen's Pension Plan | 39.9% | 24 | 27,413,402 | 68,671,042 | 41,257,640 | 7/1/2006 |
| | Policemen Pension Plan | 62.5% | 17 | 39,118,117 | 62,635,048 | 23,516,931 | 7/1/2006 |
| North Kingstow | Police Pension Fund (retired after 6/30/96) | 147.7% | 1 | 3,508,888 | 2,374,917 | (1,133,971) | 7/1/2006 |
| North Providenc | Police Pension Plan | 67.5% | 14 | 18,763,757 | 27,794,462 | 9,030,705 | 7/1/2006 |
| Pawtucket | Post 1974 Police and Fire | 42.5% | 23 | 62,097,816 | 146,146,982 | 84,049,166 | 7/1/2005 |
| Portsmouth | Employees of the Town of Portsmouth | 65.3% | 16 | 25,129,703 | 38,459,122 | 13,329,419 | 7/1/2006 |
| Providence | ERS of the City of Providence | 37.4% | 25 | 393,768,000 | 1,052,805,000 | 659,037,000 | 6/30/2006 |
| Scituate | Police Pension Plan | 37.0% | 26 | 2,510,044 | 6,778,751 | 4,268,707 | 4/1/2005 |
| Smithfield | Police (prior to 7/1/99) | 36.4% | 27 | 7,161,996 | 19,691,681 | 12,529,685 | 7/1/2005 |
| | Fire Pension Plan | 86.2% | 7 | 12,402,997 | 14,392,140 | 1,989,143 | 7/1/2006 |
| Tiverton | Policemen's Pension Plan | 49.9% | 19 | 5,490,958 | 11,006,944 | 5,515,986 | 7/1/2005 |
| Warwick | City Employees | 78.5% | 11 | 64,006,602 | 81,587,332 | 17,580,730 | 7/1/2004 |
| | Police Pension II Plan | 102.3% | 3 | 106,857,258 | 104,458,087 | (2,399,171) | 7/1/2005 |
| | Police Pension I & Ffire Pension Plan | 27.0% | 31 | 71,984,600 | 266,825,982 | 194,841,382 | 7/1/2005 |
| | Fire Pension Plan II | 86.3% | 6 | 7,571,670 | 8,774,481 | 1,202,811 | 7/1/2005 |
| | Warwick Public Schools Employee Plan | 81.0% | 8 | 30,185,621 | 37,280,441 | 7,094,820 | 7/1/2006 |
| West Warwick | Town Plan | 47.9% | 20 | 40,301,196 | 84,051,416 | 43,750,220 | 7/1/2005 |
| Westerly | Police Pension Plan | 43.4% | 22 | 18,221,293 | 41,998,644 | 23,777,351 | 6/30/2005 |
| Woonsocket | Police (pre 7/1/80) & Fire (pre 7/1/85) Plan | 100.9% | 4 | 87,976,576 | 87,180,329 | (796,247) | 6/30/2006 |
| | **Aggregate Totals** | **45.0%** | | **1,287,092,498** | **2,860,366,812** | **1,573,274,314** | |

Source: Rhode Island Auditor General, "Status of Pension Plans Administered by Rhode Island Municipalities" (page 16), July 2007

The Rhode Island Auditor General noted that, at the time of the report, 21 of the 37 pension plans were considered at risk. These plans were administered in 15 distinct communities. Seven of plans were severely underfunded and the contributions to the plans were not at 100.0 percent of the actuarial required contribution level. Annual required contributions in five of the "at risk" communities' represented 20.0 percent or more of the FY 2006 property tax levy.[iii]

Given the gravity of the situation in many locally-administered pension plans in Rhode Island, the Auditor General outlined a series of recommendations designed to improve the overall condition of these plans, especially those identified as "at-risk" including:

- Contribute no less than 100.0 percent of the annual required contribution;
- Pursue moving active members into the State-administered MERS system; and
- Consider increasing employee contributions.

Other strategies that the Auditor General identified as having further potential include:

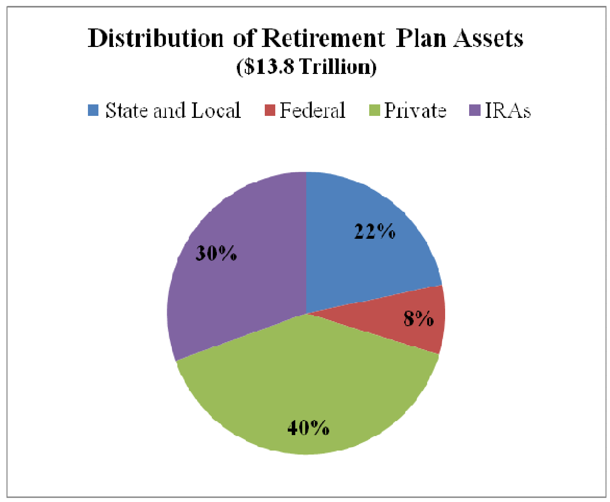
- Create a pooled investment trust for locally-administered pension plans to improve investment performance;
- Improve enforcement measures for those communities failing to make the annual required contribution, perhaps triggered by failure to meet certain funding ratios;
- Prevent the creation of any additional locally-administered pension plans; and
- Create incentives for locally-administered plans to merge with MERS.

## Characteristics of Pension Plans

### *Overview*

In 2006, state and local pension systems across the country covered 18.4 million participants, made payments to 7.3 million beneficiaries and paid out $151.7 billion in benefits. Nearly 90 percent of full time state and local employees participate in defined benefit programs.

Private pension plans are mostly 401(k) plans; however, less than half of the private workforce is covered by a 401(k) plan and the rest of the private workforce does not have a pension plan. All private employees are required to participate in Social Security. Conversely, nearly all state and local pension plans are defined benefit pension plans with nearly 100 percent participation. However, only 72.0 percent of the public workforce participates in Social Security.[iv]




State and local governments held approximately 22 percent of the total retirement assets in the U.S. in 2006 – nearly $3.0 trillion of the $13.8 trillion in pension assets. Private pensions represented approximately $5.5 trillion, or 40.0 percent of the total. Approximately $3.3 trillion of the $5.5 trillion was in defined contribution programs while the $2.2 trillion balance was in defined benefit pension plans. One should note that the majority of IRAs (Individual Retirement Accounts) are likely to be rollovers from 401(k)s - therefore, the private sector presence is much more significant.[v] An IRA is a retirement investing tool for employed individuals (and their non-working spouses) that permits annual contributions up to a specified maximum amount. An individual's income and whether they participate in an employer-sponsored retirement plan dictates whether or not a tax deduction is permitted.

Generally speaking, state-administered defined benefit pension plans represent less than 10.0 percent of the total number of state and local pension plans in the U.S. with the remaining 90.0 percent administered by local government. However, these plans represent nearly 88 percent of the participants and approximately 82 percent of the assets held in state and local pension plans nationwide.[vi] State and local pensions have an estimated $185,900 in assets per employee while private sector pension plans have an estimated $84,800 in assets per employee.[vii] This is, in part, due to the fact that only 72.0 percent of public employees are covered by Social Security compared to nearly 100 percent of private employees. Further, public defined benefit plans typically have cost of living adjustments while private plans do not. Small, local pension plans have more assets per active employee than state plans: state plans have an estimated $143,035 per active employee and local plans have $223,305 per active employee.

Not only have state and local pensions continued to experience rates of return that, on average, outperform private plans by 1.0 percent, it appears that the rate of return improved as the size of the pension plan grew.[viii] Those plans with less than $500 million in assets experienced an average yield of 9.0 percent while those with assets above $1.5 billion experienced a yield of 10.2 percent during the same period. Therefore, the size of the plan has some influence in determining return on invested assets. According to Munnell, larger plans tend to be more efficiently operated as well, with administrative expenses accounting for 0.3 percent for plans with $1.5 billion or more in assets as compared to 0.5 percent for those with less than $500 million. Public pension holdings tend to have a higher concentration in equities than those held in the private sector.

Over the past ten years, the State retirement system in Rhode Island has experienced an average rate of return of 7.4 percent. However, the current economic conditions have altered the rates of returns over the last year and have started to put additional pressures on State and local plans to meet the decreased asset values. The actuarial consultant for the State, Gabriel Roeder Smith & Company, note that the State retirement trust declined by approximately 6.0 percent in FY 2008. The impact of the -6.0 percent return in the last fiscal year is phased in slowly over the five valuations from June 30, 2008 through June 30, 2012, with prior gains from years FY 2007 and earlier offsetting part of this loss. Thus, because of the five-year smoothing in the actuarial value of assets, as of June 30, 2008, there was a $59.4 million actuarial gain for State employees. The firm also notes that the trust has had significant losses since the beginning of the current fiscal year, which is likely due to the current market turmoil and financial crisis.

**Investment Return Rate History**

| Year Ending June 30, | Market | Actuarial |
|---|---|---|
| 1995 | 17.0% | 10.2% |
| 1996 | 13.7% | 13.7% |
| 1997 | 19.1% | 19.1% |
| 1998 | 16.1% | 16.5% |
| 1999 | 10.1% | 14.7% |
| 2000 | 9.1% | 8.8% |
| 2001 | -11.0% | 4.9% |
| 2002 | -8.4% | 0.9% |
| 2003 | 2.6% | -0.8% |
| 2004 | 18.7% | 0.4% |
| 2005 | 11.4% | 1.8% |
| 2006 | 11.6% | 7.4% |
| 2007 | 18.2% | 13.0% |
| **Average Returns** | | |
| Last 5 Years | 12.4% | 4.2% |
| Last 10 Years | 7.4% | 6.6% |

Source: Employees' Retirement System of Rhode Island Actuarial Valuation Report (June 30, 2007)

While state and local pension benefits do not receive the same Federal oversight that private pensions do (neither controlled nor guaranteed), there is considerable interest in ensuring that these funds are adequate to meet their obligations. There are a number of key measures to understand the funding status of pension plans, with each providing some insight into the overall health of pension plans. One such measure is the funded ratio. Based on data as of June 30, 2007, the Rhode Island State employee pension fund has a funded ratio of 57.5 percent, and the State's teacher pension fund has a ratio of 55.4 percent. The Rhode Island municipal employee pension fund (MERS) has a funded ratio of 90.5 percent.

Nationally, the number of private defined benefit plans has decreased as have the percentage of current workers who participate in said plans. The number of defined benefit plans has declined from approximately 148,000 plans with nearly 30.1 million participants in 1980 to roughly 47,000 plans with 21.3 million participants in 2003. There has been a 68.2 percent decline in the number of plans and a 29.2 percent decrease in the number of participants in defined benefit plans since 1980.[ix]

**Changes in Private Sector Retirement Plans**

| | Defined Benefit | | | | Defined Contribution | | | |
|---|---|---|---|---|---|---|---|---|
| Year | Plans | Change | Participants | Change | Plans | Change | Participants | Change |
| 1980 | 148,096 | | 30.1 | | 340,805 | | 18.9 | |
| 1985 | 170,172 | 14.9% | 29.9 | -0.7% | 461,963 | 35.6% | 33.17 | 75.5% |
| 1990 | 113,062 | -33.6% | 26.2 | -12.4% | 599,245 | 29.7% | 35.34 | 6.5% |
| 1995 | 69,492 | -38.5% | 23.4 | -10.7% | 623,912 | 4.1% | 42.2 | 19.4% |
| 2000 | 48,773 | -29.8% | 22.2 | -5.1% | 686,878 | 10.1% | 50.87 | 20.5% |
| 2003 | 47,036 | -3.6% | 21.3 | -4.1% | 652,976 | -4.9% | 51.83 | 1.9% |
| 1980 - 2003 | (101,060) | -68.2% | (8.8) | -29.2% | 312,171 | 91.6% | 32.9 | 174.2% |

Note: Participants are in millions

Source: CRS Report for Congress, Retirement Savings: How Much Will Workers Have When They Retire? Jan 2007

Conversely, the share of the private workforce participating in defined contribution plans (and the number of plans) has risen sharply. There were nearly 19.0 million participants in over 340,800 defined contribution plans in 1980, which has since increased to 52.0 million participants in over 650,000 defined contribution plans in 2003. The number of defined contribution plans has nearly doubled since 1980, and the number of participants has increased by 174.2 percent during this period of time.[x] Data also shows that, between 2003 and 2006, the percentage of private sector workers participating in defined contribution plans increased from 40.0 percent to 43.0 percent.[xi]

While the private sector has moved from defined benefit plans to defined contribution plans, states have continued to use defined benefit plans to provide retirement benefits to their employees. In FY 2005, the Nation's state and local governments provided retirement benefits to nearly 7.3 million beneficiaries (retirees and their families).[xii] As of 2007, nearly all the states (90.0 percent, or 45 states) had defined benefit pension programs as their primary retirement plan for employees. Alaska and Michigan have both adopted defined contribution plans for general state retirees, Indiana and Oregon have adopted hybrid plans, and Nebraska has a cash balance defined benefit program as its primary plan.[xiii]

## Definition and Overview of Terms

A **Pension Plan** is a program to provide a benefit to employees who meet minimum requirements based on age and years of service to receive a portion of their salary post-employment. A pension plan represents a liability – an obligation to pay future benefits to employees. Pension plans acquire assets through contributions from employees and employers, as well as earnings on the assets invested. Assets grow when investments increase at a faster rate than assumed, benefits decline, or a combination of both. An unfunded liability occurs when liabilities exceed the assets available.

There are essentially two types of pension plans, which are very different from each other in terms of who bears the risk, how a benefit is calculated, how the funds are invested, and how they influence behavior.

A **Defined Benefit Plan** is a plan that promises a benefit to employees based on eligibility, years of service (often, under these types of plans, credit is given for outside service, such as that in the military), retirement age, and a salary base. This benefit is paid regardless of the performance of the assets in the pension fund. These plans are typically pre-funded by contributions from both employees and the employer. The plans typically have disability components, COLA provisions, and Social Security offset provisions. A defined benefit plan is generally considered a low risk to the employee in that the employer bears the risk and reward of the fund performance and actuarial performance, while the employees generally bear inflation risk and potential job loss before eligibility.

*A **defined benefit** pension plan promises a benefit to employees who meet a series of criteria.*

*A **defined contribution** plan promises a contribution to a retirement savings fund by the employer.*

*A **hybrid** plan attempts to take elements of both plans to spread the risk among employers and employees.*

Because defined benefit plans provide guaranteed lifetime income to retirees, they provide more income for career employees, which, in turn, increase the likelihood of longer service. However, this also means that, should an employee leave service prematurely, that employee stands to lose a significant investment. Therefore, defined benefit plans tend to encourage longer terms of service, reduce mobility, and can create a more expensive climate and workforce due to longer employment, which results in higher salaries and lower turnover.

Generally speaking, public employee defined benefit programs tend to have higher benefit levels than those in the private sector. In the public sector, employees participating in Social Security have a median accrual rate of 1.9 percent while those not participating in Social Security have an estimated rate of 2.2 percent, and private sector defined benefit employees have a 1.5 percent rate. These percentages are typically applied to each year of service and the final average salary. One should note that all private sector employees must participate in Social Security while public sector employee participation is not mandatory.[xiv]

A **Defined Contribution Plan** is a plan that promises a contribution to a retirement savings fund by the employer. Typically, the employer contributes a percentage of salary, often with a minimum contribution by the employee for the employer match. Most plans require workers to affirmatively elect to enroll in a defined contribution plan although an increasing number of plans automatically enroll employees (designed to increase participation). Private sector plans are almost entirely 401(k) plans.

The benefit amount is determined primarily by contribution rates and the rate of return on accumulated assets invested. Again, these plans are typically funded by contributions from both the employee and the employer. However, the employee bears the risk (and reward) based on the asset performance in the funds. Whatever is in the fund is what is available for retirement. A distinct advantage of this type of plan is that it is portable. It can also be drawn down in installments or in one lump sum.

*There are essentially four types of defined contribution plans:*

*401(k) Plans permit primarily private sector employees to defer a portion of their pay to a qualified tax-deferred plan. Employers often make contributions to these plans, but the employee typically directs the investments of the funds.*

*401(a) Money purchase plans, with employee and employer contributions structured as mandatory or voluntary - the employer decides on the method of participant contribution, as well as whether participant contributions will be made on a pre-tax (picked-up contributions) or an after-tax basis. These types of plans are available to governmental units.*

*403(b) Plans permit public education employees to defer a portion of their pay to a qualified tax deferred plan. These funds are invested in annuity contracts through insurance companies or through mutual funds. Employers often make contributions to the plans.*

*457(b) Plans permit employees to defer their pay. Employees are immediately vested in the funds, which will not be taxed until the funds are paid from the plan.*

A **Hybrid Plan** is designed to distribute the share of risk and reward between employer and employee by combining components of a defined benefit with a defined contribution plan. The Federal Employees Retirement System is one example of a hybrid plan.

**Annual required contributions (ARC)** – Actuaries annually calculate a contribution amount that would maintain or improve the funding status of a pension plan, ensuring that the amounts set aside in reserve would not only cover current benefits but a portion of estimated unfunded liabilities. A government's ability to maintain its ARC is critical and determines whether or not the entity is keeping pace with benefits accumulated. Should a government contribute less than actuarially required, the assets in the pension fund would eventually be insufficient to meet obligations, and this cost would fall on future generations of taxpayers. The most common reason for a government to underfund its contribution is financial crisis. However, to minimize significant fluctuations in the ARC, state and local governments often use smoothing techniques, which use the average of the plan's assets over a number of years to determine the contribution rates.

**Funded ratio** - represents the percentage of plan liabilities covered by the plan assets. Low ratios will eventually require additional funding, either from government or employee contributions. In a Government Accountability Office (GAO) study that used data from 2006, 58.0 percent of the 65 state and local public plans evaluated were funded at or above the 80.0 percent threshold. This represents a slight decline since 2000.[xv] According to the GAO report, state and local governments would have to increase pension contribution rates from 9.0 percent to 9.3 percent of salaries to ensure appropriate funding for pension funds on an ongoing basis.

**Unfunded Actuarial Accrued Liability (UAAL)** – The dollar amount of benefits accrued for which no funds are set aside to cover. An unfunded liability indicates the degree of accumulated liabilities over assets. Unfunded liabilities can occur when state and local governments fail to make the full contribution to the fund, actual returns on investments of the assets are lower than assumed, or there is an increase in benefits. Demographic factors, such as age of retirement and longevity can increase the liability as well. Faltering pension assets due to low contributions, poor investment returns, and inaccurate demographic factors can translate into greater fiscal and budgetary problems for the future.

**Cost of living provisions (COLA)** – for pension benefits are designed to ensure that the benefit does not erode over time due to inflation costs. These provisions vary among the states, and differ if states have multiple tiers or schedules for their pension systems.

## Notes

[i] GAO Employee Compensation:  Employer Spending on Benefits Has Grown Faster Than Wages, Due Largely to Rising Costs for Health Insurance and Retirement Benefits, February 2006 (GAO-06-285).
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