BEST PRACTICE


Background. The retirement benefit is a form of compensation designed to assist the employer in the recruitment and retention of public employees and other workforce management goals. It is also provided to assist employees in preparing for retirement and compensate individuals for their years in public service.

Broadly speaking, there are two types of retirement plans, defined benefit and defined contribution. Defined benefit plans, with very few exceptions, provide a retirement benefit calculated using a formula based upon a plan participant’s years of service and compensation. Generally, both employers and participants contribute to these public sector defined benefit plans. All assets accumulated to fund the retirement benefits are invested by the retirement board or a central agency responsible for investing government funds. All investment-related risk is generally borne by the employer. These plans are predominant in the public sector, covering over 90 percent of full-time public sector employees.¹

Principal features of defined benefit plans generally include:
1. Investment risk born by the plan sponsor;
2. Life expectancy risk born by the plan sponsor;
3. Survivor and disability coverage generally provided;
4. Guaranteed lifetime annuity to members at retirement unless they choose an alternate payment method;
5. Investments directed by the plan;
6. Generally lower investment costs associated with a defined benefit plan as compared to other plan designs;
7. More useful tool for employers to attract and retain employees for full careers and to manage workforce levels; and
8. Guaranteed or ad-hoc cost-of-living adjustments provided to annuitants.

A defined contribution plan provides for benefits based solely on the assets available in an employee’s individual account, to which both employees and employers may contribute. All employees have their own accounts set up within the plan to which contributions and investment gains and losses are recorded. Typically, under a defined contribution plan, employees direct the investment of their contributions among investment options selected by plan trustees, the employer or the employer’s designated agent and therefore fully bear the investment risk. The dollar amount accumulated in a defined contribution plan will vary depending upon the amount contributed to the plan, the investment performance, the level of risk taken, and the fees paid.

Principal features of defined contribution plans generally include:
1. Portable vested benefits;
2. Employer obligations fulfilled annually as contributions are made, so there is no unfunded liability;
3. Investments directed by participants;
4. Account balances at retirement dependant upon a combination of investment rate of return, contribution levels and the period of investment;
5. Easier to understand account values as participants can see their balance on a regular basis;
6. Investment risk and fees born by participant;
7. Life expectancy risk born by the participant;

8. No cost of living allowances after retirement; however, participants continue to earn investment income on their remaining assets; and
9. Neither disability nor survivor coverage generally provided.

In addition to defined benefit and defined contribution plans, some entities provide retirement benefits through “hybrid plans” that incorporate features of both defined benefit and defined contribution plans.

For any of these plans, the actual costs to plan sponsors and participants are determined by the number and amount of benefits actually paid to recipients, and the source and amount of plan contributions and investment returns.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that state and local governments have a policy statement that will guide their on-going plan design decisions. This policy should encourage governments to provide sustainable and properly funded retirement plans, which will attract employees in a competitive labor market, facilitate effective management of the workforce, and fulfill retirement needs.

In developing a policy for retirement plan design, a state or local government should consider the following:
- Purpose of the retirement plan (e.g., level of replacement income and purchasing power retention);
- Ability of public retirees to contribute to the economic viability of their community and not become a financial liability to the community in which they live due to inadequate retirement income;
- Organization’s philosophy regarding employer and employee responsibilities in preparing for retirement;
- Availability of Social Security, retiree medical benefits, disability and survivor benefits, and supplemental (e.g. 457) savings plans;
- Costs, including the employer’s ability to sustain payments and perhaps increase benefits over time and cost predictability;
- Labor market considerations such as competitive environment, workforce mobility, length of employee service, and recruitment and retention of employees;
- Investment risk and control, including how investment risk is allocated between employer and employee;
- Portability of benefits;
- A plan design that can be communicated to and understood by plan participants;
- Employee educational efforts; and
- Advantages of the different types of plans (e.g., defined benefit, defined contribution, and hybrid.)

**References**


Approved by the GFOA’s Executive Board on March 2, 2007.