BEST PRACTICE

Designing and Implementing Sustainable Pension Benefit Tiers (2011)

**Background.** In times of fiscal stress many state and local governments face formidable financial challenges that will require difficult decisions to ensure the continued sustainability of their pension plans. Economic cycles, combined with funding deficiencies and enhanced benefits, can create unfunded liabilities for these plans. As state and local governments review total compensation packages in an effort to manage future costs and ensure sustainability, many are changing the structure of their employee pension benefits. One of the changes some governments have made is to limit existing pension benefits to current employees and create lower-cost pension benefit tiers for new employees. Such tiers may combine defined benefit and defined contribution plan designs. In some cases, these changes can also be applied to existing employees.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that jurisdictions considering new benefit tiers examine the following issues: A government’s authority to revise its pension benefits, the overall goals it wants to accomplish by doing so, and the effect of such changes on the workforce; and the financial impacts resulting from changes to pension plan design, as well as the effects on employees. The GFOA further recommends that as governments consider new benefit tiers they solicit input from actuaries during the analysis, design, and implementation related to forecasting benefit costs, determining funding adequacy, and making decisions regarding employer and employee contribution rates.

In examining the first set of issues, GFOA recommends the following review process:

1. **Identify and address legal constraints.** Consult with legal counsel to identify any federal and state legal impediments. In some states, there may be a legal foundation for changing current employees’ pension benefits prospectively. However, many states have constitutional restrictions, statutory provisions, or case law limiting or proscribing such changes. Governments should also review collective bargaining laws, labor contracts, and other potential restrictions such as local ordinances and plan documents before embarking on plan design changes.

2. **Identify financial sustainability goals.** Identify key factors that are likely to affect the financial sustainability of current benefit levels. Based on this information, establish a pension benefit cost goal for the overall plan, for particular employee groups, and/or for each benefit tier. This target gives employers a fact-based context for evaluating alternative benefit tier designs.

3. **Review total compensation and the impact of pension benefit tiers.** Consider how the government’s total compensation package compares to those of other employers in the labor market in which it competes and how current benefits support workforce management objectives. Total compensation that exceeds market rates creates unnecessary costs for taxpayers, compensation that falls below market rates may eventually impair the quality of services the government delivers. Employers also need to keep in mind the effect of pension benefit tiers on the equitable treatment of employees, employee morale, and the jurisdiction’s ability to recruit, motivate, and retain employees.

4. **Investigate alternative plan design options.** Conduct a broad review of options. Some public employers offer new employees a hybrid plan that includes a mix of defined benefit and defined contribution features. Hybrid structures take many forms that can be customized for an employer’s workforce. (See the GFOA’s best practice on Essential Design Elements of Hybrid Retirement Plans.)

5. **Reconsider Other Postemployment Benefits (OPEB).** Along with pension benefits, retiree medical benefits should be sustainable and competitive. Developing a new tier for pension benefits offers an opportunity to evaluate the design of
OPEB benefits, identifying alternative benefits or plan designs that have the potential to control costs and increase long-term sustainability. (See the GFOA’s best practice on Ensuring the Sustainability of Other Postemployment Benefits.)

The second set of issues relates to understanding how changes in key plan design elements will affect the government’s financial goals and its employees. (See the GFOA’s best practices on Essential Design Elements of Defined Benefit Plans, Defined Contribution Plans, and Hybrid Retirement Plans.) These elements include:

1. **Retirement ages.** Normal Social Security retirement age is now 67 for Americans who were born after 1960. In light of this, employers should consider recalibrating normal retirement ages for new hires. Where legally permissible and appropriate, governments might choose to incrementally increase the retirement age for current employees, provided the change does not affect protected accrued benefits. Governments that provide early retirement should recognize the actuarial cost of this practice, and they should consider funding the early retirement benefit through both employer and employee contributions. (See the GFOA Advisory on Evaluating the Use of Early Retirement Incentives, which recommends extreme caution if considering early retirement incentives.)

2. **Pension formula multipliers.** When establishing multipliers for pension benefits, consider the amount of income the pension is designed to replace in retirement, taking into account the availability of Social Security, Medicare, employer-provided retiree medical benefits, and the amount of personal savings employees can reasonably be expected to have at retirement. Employers might also consider whether it is appropriate to limit the maximum benefit to a specified percentage of final average earnings.

3. **Cost of living allowances (COLAs).** If a system provides a COLA, it must be actuarially funded for the system to remain financially sound. If new benefit tiers are established, they should have affordable COLA limits while also providing sufficient inflation protection for retirees. (See the GFOA’s advisory on Responsible Management and Design Practices for Defined Benefit Pension Plans.)

4. **Employee contribution requirements.** Governments that do not already require employee contributions may need to consider establishing them. Governments that create new, lower-benefit tiers for new employees may also wish to consider different contribution rates for existing and new employees to provide some level of equity between the groups.

5. **Benefit enhancements.** Governments that establish new benefit tiers should express their intent to make future changes only on a prospective basis, in order to avoid increasing pension liabilities through retroactive modifications, and should include this intent in all policy statements and plan documents that explain new benefit tiers. (See the GFOA’s advisory on Responsible Management and Design Practices for Defined Benefit Pension Plans.)

6. **Purchase of service credit.** Governments should consider whether they will permit employees to purchase service credit within or among the jurisdiction’s benefit plans. Governments that allow employees to purchase service credits in new benefit tiers should ensure that the cost of such credits is based on an actuarial valuation.

7. **Anti-spiking provisions.** Governments should consider including provisions that exclude extraordinary income from final average compensation calculations in their new benefit tiers. Extraordinary income includes lump sum payouts of vacation, sick, and compensatory time as well as extraordinary overtime pay. Allowing these payments to be included in final average compensation increases retirement system liabilities, often without prefunding and often amortized over an extended period of time, long after the employee’s period of active service.

8. **Vesting periods.** Governments should evaluate potential impacts on employee recruitment and retention before implementing longer vesting periods for new hires, which might decrease plan liabilities.

9. **Notice to employees and transition issues.** In making changes to current employees’ pension benefits, governments need to provide ample time and sufficient notice so participants can adapt to such changes. A multi-year implementation may help employees adjust. New employees should receive specific information on the particular benefit tier that applies to them. (See the GFOA’s best practice on Preparing an Effective Summary Plan Description for Retirement Systems.) In addition, governments should clearly indicate how benefit tiers will apply when employees are rehired or are transferred within the organization.

**Notes**

1 A tier refers to a group whose benefit formulas are different from those of other pension plan members, usually predecessor employees. For example, a new benefit tier might apply to employees hired after a specific date, while those hired previously receive different benefits. In states where laws allow, a new tier can also be established for current employees hired after a certain date.


3 If state law allows public employers to change plan benefits prospectively for current employees, this right should be clearly stated in the plan documents that are distributed to employees. If there is no explicit or implied contract that entitles an employee to accrual of benefits indefinitely under the current benefit structure for future service, this should be clearly stated in the plan documents as well. Consult with legal counsel to ensure that such descriptions do not violate the requirement that benefits be “definitely determinable” under Internal Revenue Code 401(a). Generally, a plan does not provide definitely determinable benefits if a member’s ability to receive the benefit is conditioned on the employer’s discretion, absent plan changes.

Employers should consider whether state and local government employees’ total compensation, which includes both salary and all benefits, may be less than their private sector counterparts with comparable education and experience. (See “Out of Balance? Comparing Public and Private Sector Private Compensation Over 20 Years,” *Center for State and Local Government Excellence*, 2011.) Jurisdictions should also take into account the total compensation available to current and future employees, including any Social Security coverage.


For example, a lower multiplier may be sufficient for general employees who have Social Security and a Medicare benefits supplement, but a higher multiplier might be more appropriate for employees who are outside of Social Security. Moreover, multipliers are generally lower for hybrid plans that combine a defined benefit plan with a defined contribution plan.

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