SCRS Pension Explainer: New Employees Are Not Necessary to Fully Fund a Pension Plan

There is a commonly held belief that defined benefit pension plans like SCRS need contributions from new employees to help pay for the pension benefits promised to retirees. However, this is not true. The confusion is because Social Security operates by having new members contribute to fund benefits for current beneficiaries. But the funding process for defined benefit plans is actually quite different from Social Security.

1. Defined Benefit Plans Are Designed to be "Pre-funded"

Defined benefit retirements are designed so that annual contributions into the pension fund paid at the same time that an employee accrues benefits are enough to pay for those benefits when the employee retires. Actuaries estimate what the retirement benefit an employee is likely to earn, and then spread out the contributions necessary to pay for those benefits over that employee's career.

The goal is to have enough money in the pension fund so that – when combined with expected investment returns – there will be enough dollars in the fund the day that the employee retires to pay all benefits throughout retirement.

2. Employees Contribute Towards the "Normal Cost" of Pensions

The annual contributions necessary to "pre-fund" retirement benefits are called "normal cost" and they are shared between employees and employers. When investment returns are less than expected, or reality differs from other actuarial assumptions, the result is unfunded pension liability. In South Carolina, employers — i.e. the state and municipalities — pay the "unfunded liability amortization payments" (see other side).

The employee contributions in SCRS only go towards the normal cost, meaning employee contributions only help fund their own retirement benefit. For SCRS today employees do not contribute toward paying down unfunded liabilities.

3. New Employees Mean More Promised Pensions

Every new state and local hire increases the cash flow into SCRS through more total employee contributions, but every new employee also means an increase in the "accrued liabilities" or promised pension benefits that will have to be paid out of SCRS when these new employees retire.

Hence, adding more employees on its own does not by itself improve the funded status of the defined benefit plan.

Questions about this explainer or pension reform? Check out www.reason.org/SCRS

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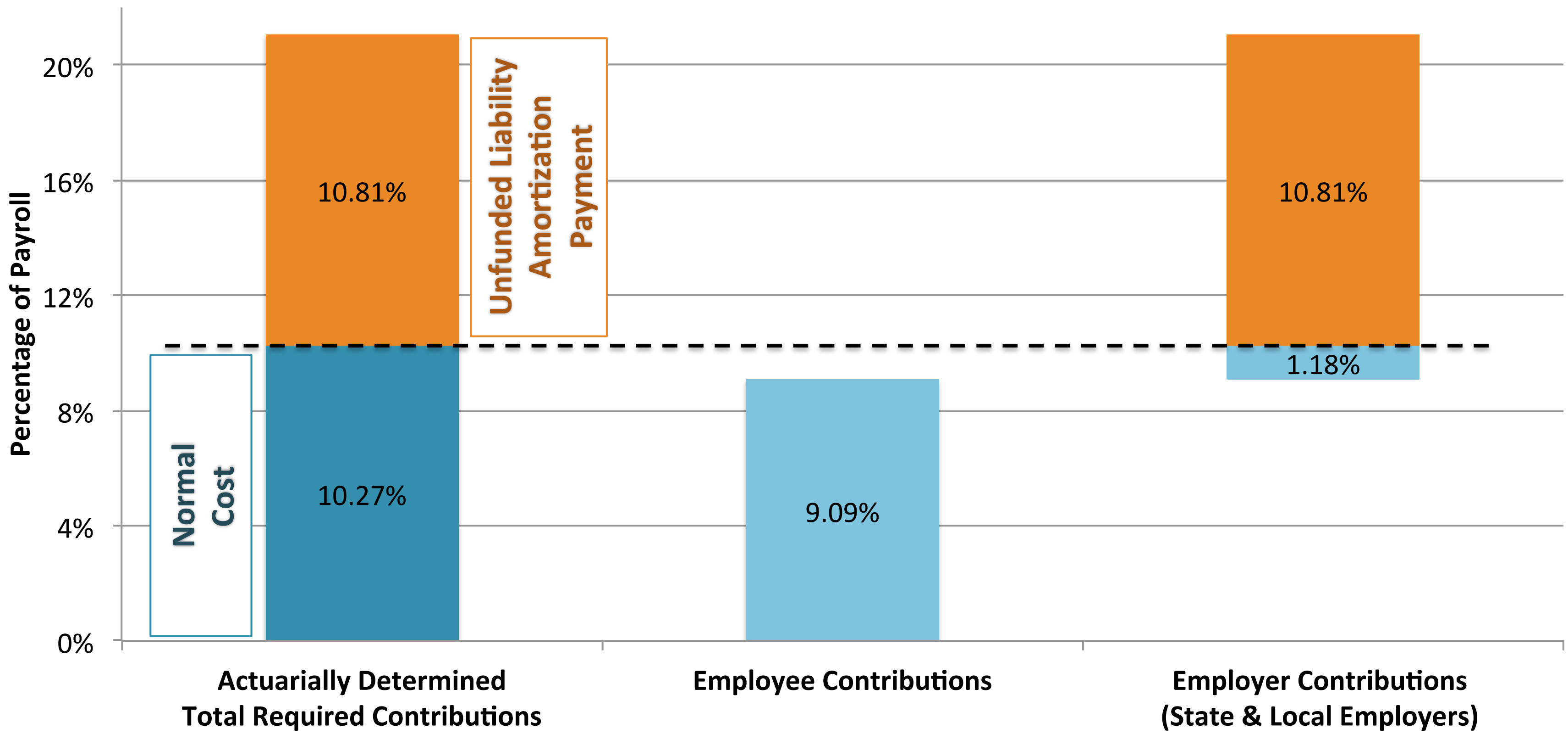
SCRS Breakdown of Employer v. Employee Contributions For Fiscal Year 2018



Source: SCRS Fiscal Year End 2016 Valuation Report, p.16