North Carolina
Future of Retirement
Study Commission

Considerations for Labeling Contributions as Employee vs. Employer

Economically, there is no difference between a mandatory employee contribution and an employer contribution. To demonstrate this, consider the following options for contributions to a plan that credits both employee and employer contributions to individual accounts and immediately vests employer contributions:

	Option A	Option B	Option C
Base Pay	$50,000	$45,000	$47,500
Employer Pension Contribution	$0	$5,000	$2,500
Mandatory Employee Pension Contribution	$5,000	$0	$2,500
Net Pay	$45,000	$45,000	$45,000

If tax rules provide full flexibility, a rational individual should be indifferent between these three options because the total retirement contribution and net pay are the same. In reality, tax rules do not provide full flexibility and people do not think rationally about certain economic decisions. Here are the major considerations for the two contribution types:

Employer Contributions

- Employees may under- or over-estimate value of retirement benefits. Under-estimating is probably more likely, although less likely in the public sector than the private sector. At the same time that they underestimate the present value of benefits, they may overestimate the monthly payment at retirement.
- If the employer makes some contributions to a DB plan, employees are likely to expect the employer to make up any underfunding through increased contributions without an offsetting decrease in regular pay.
- In a DC plan, a cut in the employer contribution is often not perceived as negatively as a cut in base pay.
- Employer has more flexibility on vesting.
- Employer may perceive it as unfair if they pay more into the retirement system than the employee.

Employee Contributions

- Employee may perceive it as unfair if they pay more into the retirement system than the employer.
- Federal tax rules place lower ceilings on employee contributions.
- Have to pay FICA taxes on employee contributions, although you also get credit in the calculation of Social Security benefits.
- Employer may feel less ability to mandate or default certain choices, such as annuitization at retirement.
- Employees feel more ownership of benefits. This may lead them to learn more about the benefits and to demand more of a role in running the system.

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- Most DB systems credit employee contributions, but not employer contributions, to an individual account. This allows everyone to get something back from the system, although it might also encourage employees to withdraw their contributions and lose their right to a future benefit.
- Could reduce “pension envy” from taxpayers.