

A traditional pension requires another kind of teaching because there may be no visible account balance for the worker to manage. Its center is a promise: complete the required service, reach the proper age, and the employer's plan will pay an income calculated under a written formula. That change—from accumulating a personal balance to earning a future payment—is what gives the traditional pension its own character. The worker is not trying to determine how long a pile of savings will last; the plan is determining how much income the worker has earned.

A traditional pension is formally known as a defined benefit plan. “Defined” means established by the plan's rules, while “benefit” means the retirement payment the participant is entitled to receive. The plan may promise an exact amount, such as \$100 a month for every year of service, but most plans use a formula involving salary, service time, age, or some combination of those factors. The employee's retirement benefit is therefore not determined by whether the stock market performed well during the final year of employment. The market still matters to the pension fund behind the scenes, but the promised payment is based on the plan formula. This distinction is why federal retirement law places traditional pensions in a different category from 401(k)s and other defined contribution accounts.

The simplest way to understand a pension is to imagine a worker named Denise who has completed thirty years with the same public employer. Her pension formula gives her 1.5% of her final average salary for every year of credited service. “Final average salary” means the average of the salary years selected under the plan, perhaps the highest three or five consecutive years. If Denise's final average salary is \$60,000, the calculation begins by multiplying 1.5% by thirty years. That equals 45%, and 45% of \$60,000 produces a pension of \$27,000 per year, or \$2,250 per month before taxes and any reductions. Denise's pension was not created by someone simply deciding that \$2,250 sounded fair; every part of it came from the plan's written formula.

The multiplier—the 1.5% in Denise's example—has enormous influence over the final result. If the same worker had a 2% multiplier, thirty years would produce 60% of final average salary instead of 45%. Her annual benefit based on a \$60,000 salary would rise from \$27,000 to \$36,000. A difference of half a percentage point may look small when written on paper, but repeated across thirty years of service it can change retirement income by hundreds of thousands of dollars over a lifetime. This is why two workers with similar salaries and careers can receive very different pensions. Their employers may use different multipliers, salary periods, retirement ages, survivor rules, and cost-of-living provisions.

Credited service is the time the pension plan agrees to count toward the formula. It may include ordinary years worked, but plans can have special rules for part-time employment, unpaid leave, military leave, temporary positions, breaks in service, and previous employment with a related government agency. Some public plans permit an employee to purchase service credit, meaning the employee pays an amount to have

certain eligible years added to the pension calculation. Purchasing five years does not necessarily mean retiring five years earlier; the purchased time might increase the benefit without satisfying every eligibility requirement. A worker should never assume that calendar time and pension credit are identical. The official service record, not the employee's memory of a starting date, controls the calculation.

Salary also needs closer examination because a pension plan may not count every dollar shown on a paycheck. Base salary is commonly included, while overtime, bonuses, unused leave, allowances, and special payments may be included, limited, averaged, or excluded. Some plans have anti-spiking rules designed to prevent a benefit from being artificially enlarged by an unusual jump in compensation near retirement. A worker earning substantial overtime during the final year may expect it to increase the pension, only to discover that the plan excludes it or limits the amount counted. Final average salary is therefore a technical plan term, not simply the worker's last annual earnings. The summary plan description or official pension handbook explains which compensation the formula recognizes.

Before a worker can keep an employer-funded pension benefit, the worker usually must become vested. Vesting means earning the permanent right to the benefit already accumulated. A plan might require five years of service before full vesting, although the schedule varies among plans and employment systems. Someone who leaves after four years under a five-year vesting requirement may receive no employer-funded pension, even though the person was covered by the plan during those years. A worker who leaves after becoming vested can generally preserve the benefit and claim it later, even without remaining with that employer until retirement age. The postponed payment is called a deferred vested pension.

A deferred pension can be valuable, but its future purchasing power deserves attention. Suppose a worker leaves at age forty with a vested benefit of \$800 a month beginning at sixty-five. If the plan does not increase that amount while the worker waits, the future \$800 will buy less than \$800 buys today because prices will probably rise over twenty-five years. The benefit has not disappeared, yet inflation has weakened what it can purchase. This is one reason an employee should not judge a pension only by the stated future payment. The waiting period, inflation protection, retirement age, and other retirement resources determine what that payment will actually mean.

Becoming vested does not automatically mean someone can retire immediately with an unreduced pension. Most plans establish a normal retirement age or a combination of age and service at which the full earned benefit becomes payable. A plan might allow full retirement at sixty-five, at sixty with a certain number of years, or when age and service together reach a specified number. Early retirement may be permitted, but the monthly amount is often reduced because payments are expected to begin sooner and continue longer. A 5% reduction for each year before normal retirement age would reduce a \$2,000 monthly pension to \$1,500 if it began five years early. The retiree receives checks sooner, but accepts a smaller amount for the remainder of life.

Some pension systems offer special treatment to workers in physically demanding or hazardous occupations. Police officers, firefighters, correctional officers, and military personnel may qualify for retirement at younger ages or under different service formulas. These provisions recognize that performing certain work for forty or fifty years may be unrealistic. They can also make the pension appear unusually generous when compared with an ordinary office-worker plan, even though the eligibility rules, employee contributions, physical risks, and career expectations are different. A pension should be evaluated within the employment system that created it. Pulling out one attractive number without the surrounding conditions produces an incomplete picture.

Reaching retirement brings a decision that can affect both the worker and the worker's family for the rest of their lives. A single-life pension normally provides the largest monthly payment because it is based on one person's lifetime. When that retiree dies, the payments usually stop. A joint-and-survivor option pays a smaller monthly amount while the worker is alive but continues a chosen percentage to the surviving spouse or another permitted beneficiary. For example, the retiree might accept \$2,050 a month instead of \$2,250 so that a spouse will continue receiving a benefit after the retiree's death. The reduction is the cost of extending protection across two lives rather than one.

Married participants in many private-sector pension plans are generally protected by a qualified joint-and-survivor annuity unless the spouse properly consents to another permitted form. Public pension systems may operate under state or local rules instead of the federal private-plan requirements, but they commonly offer survivor arrangements of their own. The election should not be made merely by choosing the largest number on the paperwork. The couple's ages, health, life insurance, separate savings, other pensions, and dependence on the monthly income all matter. Once pension payments begin, the selected form is often difficult or impossible to change. A decision made during retirement processing can therefore continue long after the retiree is gone.

Survivor protection can also matter when a vested worker dies before retirement. Many plans provide a pre-retirement survivor benefit for a qualifying spouse, but the amount and eligibility conditions vary. The spouse may need to wait until the age when the worker could have begun receiving benefits, and the payment may be smaller than the worker's projected pension. A former spouse may possess rights under a divorce order, while a current spouse may be protected by plan rules that cannot simply be erased through a will. Beneficiary forms, marriage records, divorce documents, and pension records should agree with one another. A family should learn these rules while the participant is alive and able to correct mistakes.

Inflation creates one of the greatest differences among pensions. Some plans provide a cost-of-living adjustment, commonly called a COLA, which periodically increases payments to help offset rising prices. The increase might match part of inflation, be capped at a certain percentage, depend on the plan's funding condition, or require approval rather than occurring automatically. Other pensions remain level for life. A fixed payment of \$2,500 a month may feel comfortable when retirement begins but become

increasingly limited after twenty years of higher housing, food, insurance, and medical costs. A pension is guaranteed according to its terms, and those terms may promise lifetime payments without promising lifetime buying power.

Although the pension formula focuses on the promised benefit, real money must exist to support that promise. The employer places contributions into a pension trust, where professional managers invest the pooled assets. An actuary—a specialist who uses mathematics to estimate long-term financial obligations—calculates how much the plan should have today to pay benefits expected many years from now. The actuary considers employee ages, salaries, expected retirement dates, life expectancy, investment returns, and other assumptions. If the assumptions are too optimistic or the employer contributes too little, a funding shortage can develop. The worker may never select an investment fund, but investment management and financial forecasting still operate underneath every pension check.

The common description that pensions are funded entirely by employers is not universally correct. Many private pensions are primarily employer-funded, but numerous state and local government pensions require workers to contribute a percentage of every paycheck. A teacher might contribute 7%, a firefighter 10%, or another worker a different amount established by law or collective bargaining. Those employee contributions may help finance the lifetime benefit without creating an individual investment account like an IRA. If the employee leaves, the plan may offer a refund of personal contributions, but accepting that refund can cancel the right to a future pension. What appears to be a simple return of money may actually surrender a far more valuable lifetime benefit.

A pension plan's funded status compares its assets with the estimated value of the benefits it owes. A plan that has \$90 million in assets against \$100 million in estimated obligations has a 90% funded ratio. Being less than 100% funded does not necessarily mean the plan is about to stop paying benefits, because many obligations will not be due for decades and future contributions will continue arriving. Persistent and severe underfunding, however, places pressure on the employer, taxpayers, workers, retirees, or all four. Governments may increase contributions, adjust benefits that have not yet been earned, raise employee contribution rates, or change rules for newly hired workers. Funding reports reveal the health of the entire pension system, while an individual benefit statement shows what one participant has earned.

Private employers may freeze a pension plan, which means some or all future benefit growth stops. In a hard freeze, participants generally keep benefits already earned but do not earn additional pension credit after the freeze date. In a soft freeze, existing employees may continue under some rules while new employees are excluded, or salary growth may stop affecting the calculation even though service credit continues. A frozen pension is not the same as an erased pension. Benefits already accrued under a private plan are generally protected, but the retirement amount someone expected to build over a complete career may no longer be available. Employees affected by a freeze often need to increase savings elsewhere because the pension has stopped growing.

Certain private-sector defined benefit plans are insured by the Pension Benefit Guaranty Corporation, or PBGC. This federal agency steps in when a covered pension plan terminates without enough money to pay all promised benefits. PBGC protection is valuable, but it is not unlimited; federal law caps the amount and may restrict recently increased benefits, early-retirement subsidies, and other plan features. State and local government pensions are not insured by PBGC, and certain church plans and other arrangements may also fall outside its coverage. A worker should verify whether the particular plan is insured instead of assuming every pension carries the same federal guarantee. PBGC explains which private pensions it protects and the limits of that protection.

Some pension plans offer a lump sum in place of lifetime monthly payments. The lump sum is the estimated present value of the future pension, meaning the plan converts years of expected payments into one amount today using interest rates, life-expectancy assumptions, and federal calculation rules. Accepting it gives the retiree control over investing, spending, and leaving the remaining money to heirs. It also transfers longevity risk—the danger of living longer than the money lasts—from the pension plan to the retiree. Market losses, excessive withdrawals, fraud, poor advice, or an unexpectedly long life can exhaust a lump sum. The monthly pension usually offers less flexibility but continues according to the chosen payment form regardless of how old the retiree becomes.

Interest rates can cause a lump-sum offer to change even when the monthly pension formula remains the same. Higher interest rates generally reduce the amount needed today to produce a particular future income, so rising rates can result in a smaller lump-sum calculation. Lower rates often have the opposite effect. This does not automatically make a lump sum good or bad; it explains why the offer may move sharply from one calculation date to another. A fair comparison must consider the pension's survivor benefit, expected lifetime, inflation protection, investment costs, taxes, and the value of having dependable income. Comparing only the lump sum with a few years of pension checks ignores the possibility of receiving those checks for thirty years or longer.

Pension payments are generally taxable as ordinary income to the extent they come from untaxed employer money or pretax employee contributions. If the worker made after-tax contributions, part of each payment may be treated as a tax-free return of that already-taxed money. An eligible lump sum can often be transferred directly into a traditional IRA or another retirement plan, postponing income tax until later withdrawals. When the taxable distribution is paid to the participant instead, mandatory withholding may apply even if the participant intends to complete a rollover afterward. A direct rollover avoids that withholding problem and reduces the chance that the money will be accidentally spent. The IRS explains the taxation and rollover treatment of pension distributions.

Divorce can divide a pension even when retirement is years away. In many private plans, a qualified domestic relations order—usually shortened to QDRO—is the court order that instructs the plan to pay an approved portion to a former spouse or another alternate payee. Government pension systems may use a different name or legal process. The plan administrator does not simply divide the benefit because a divorce decree says retirement property should be shared; the order must satisfy the plan's technical requirements. Years of marriage overlapping years of pension service are often important, but state law and the actual order control the result. Ignoring the pension during a divorce can leave both people with expectations the plan is not legally permitted to honor.

A pension and Social Security are separate benefits. Many pension-covered workers also pay Social Security taxes and can qualify for both benefits, while certain state and local employees work in positions that do not participate in Social Security. The Windfall Elimination Provision and Government Pension Offset once reduced Social Security benefits for many people receiving pensions from noncovered public employment. The Social Security Fairness Act, signed in January 2025, repealed those reductions for benefits payable from January 2024 forward. That repeal does not create Social Security credits for work on which no Social Security tax was paid; it removes the special reductions that had been applied when the worker or spouse qualified through other covered employment. A pension estimate and a Social Security estimate should therefore be examined separately before they are combined into a retirement-income projection.

The most useful pension document is not a general article or a coworker's explanation. It is the participant's own summary plan description, pension handbook, annual statement, or official benefit estimate. That material reveals the multiplier, credited service, recognized salary, vesting status, retirement ages, early-retirement reductions, survivor options, COLA provisions, and available lump sum. Errors deserve prompt attention because payroll history and employment records become harder to reconstruct after several decades. Workers should keep copies of benefit statements, employment dates, marriage records, divorce orders, and written explanations of purchased service. A pension may feel automatic, but preserving the evidence behind it requires attention.

The traditional pension changes the meaning of a working year. A year is not merely twelve months of salary; once credited under the plan, it becomes another piece of future income. Thirty years of service can be transformed into a monthly payment that arrives after the timecards, uniforms, meetings, night shifts, and daily travel have ended. Its strength is continuity: the retiree does not have to sell investments every month or guess how long life will last. Its limitations are equally real, including vesting rules, reduced early benefits, inflation, limited portability, and permanent payout decisions. Properly understood, the pension is deferred compensation—a portion of the value created during a career, delivered back to the worker as income from labor already completed.