TRADITIONAL DEFINED BENEFIT PENSION PLANS:

A Tried and True System That Benefits Taxpayers

The traditional public pension system is the best way to ensure taxpayers can reliably receive vital services. It's a cost-effective, proven and stable method to attract and retain qualified people to perform critical public sector work.

Dismantling and replacing the traditional pension system with new private accounts will result in higher costs for taxpayers and bureaucratic chaos.

The traditional pension system works - and has for more than 100 years. It is flexible and provides vital services to taxpayers at a low cost. Further, it provides a modest and stable retirement income for workers who have dedicated their career to serving the public.
FACTS ABOUT PUBLIC PENSIONS

The public pension system safeguards the delivery of vital taxpayer services.

Taxpayers will pay MORE to move to millions of private accounts.

The traditional public pension system is sound.

Funding shortfalls can be avoided.

The traditional public pension system is a vital stimulus to the economy.

States that have attempted a radical reform of public pensions have failed.

Taxpayers will foot the bill for workers who outlive inadequate, unstable retirement income.
The Disadvantages of Replacing Defined Benefit Plans with Defined Contribution Plans for State and Local Governments, Their Employees and Taxpayers

Legislation has been proposed in several states to replace state and local government defined benefit (DB) retirement plans with 401(k)-type retirement accounts called defined contribution (DC) plans. The issue is not whether state and local employees should have access to DC plans – most already do in conjunction with their DB plans or else through DC-type plans, which play a useful role in providing supplemental, tax-deferred retirement savings. Rather the question is whether defined benefit plans should be eliminated and replaced with defined contribution plans.

While recognizing defined contribution plans are useful in providing supplemental retirement benefits, there are distinct advantages of maintaining state and local DB plans and disadvantages against replacing them with DC plans. Eliminating a DB plan and switching to a DC plan is a lose-lose situation for governments, their employees, and taxpayers for the reasons listed below.

1. Switching to a DC plan will cost state and local governments more over the short-term. Long-term cost savings are uncertain at best.

2. Almost all state and local DB plans provide disability and survivor benefits as well as retirement income. Switching to a DC plan would require employers to obtain these benefits from another source, and at a higher cost.

3. DB plans enhance the ability of state and local governments to attract qualified employees and retain them throughout their careers. Switching to a DC plan would limit this ability, possibly producing or exacerbating labor shortages in key service areas by increasing employee turnover rates. Higher turnover rates result in increased training costs and lower levels of productivity that can, in turn, result in the need for a larger total workforce.

4. DB plans help state and local governments manage their labor force by providing flexible incentives that encourage employees to work longer or retire earlier, depending on the circumstances. Switching to a DC plan would limit this flexibility and make these incentives more expensive for the employer.

5. DB plans lower overall retirement benefit costs by pooling the risks of outliving retirement benefits and investment losses over a relatively large number of participants. Switching to a DC plan would require each individual to bear these risks alone, consequently requiring higher contributions than if the risks were pooled.

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Examples of DC-type plans available to state and local employees include 457 governmental deferred compensation plans and 403(b) annuities. In addition, some state and local employees are also covered by 401(k) plans, if the plans were established before May 6, 1986. According to testimony by the National Association of Government Defined Contribution Administrators before the U.S. House Ways and Means Oversight Subcommittee on March 23, 1999, 48 states and over 5,000 local governments have 457 plans, through which an estimated 8 million employees save for retirement. This is over 40 percent of the nation’s state and local government employees.
6. DB plans earn higher investment returns and pay lower investment management fees than DC plans. Switching to a DC plan is likely to lower investment earnings used to finance retirement benefits and increase management costs, to the detriment of plan members.

7. DB plan investment earnings reduce future employer contributions. Switching to a DC plan would prevent state and local governments from reducing employer contributions through investment earnings, which currently fund over two-thirds of public retirement benefits.

8. DB plans provide secure retirement benefits based on a person’s salary and period of service. Switching to a DC plan result in lower and less secure retirement benefits for many long-term governmental employees, including teachers, police officers, and firefighters, who constitute over half of state and local government workers. State and local employees who are without Social Security coverage would be put at even greater risk.

9. DB plans help sustain state and local economies by providing adequate retirement benefits for a significant portion of the workforce. Switching to a DC plan may slow state and local economies, since a large number of retirees would likely receive lower retirement benefits.

10. Switching to a DC plan is likely to result in pressure on state and local governments to increase DC plan benefits and provide additional financial assistance for public sector retirees.

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BACKGROUND

State and local government retirement plans in the United States cover 14 million active employees (about 10 percent of the U.S. labor force) and 6 million retirees,\(^3\) including teachers, police officers, firefighters, legislators, judges, and general employees. In 2003, state and local retirement plans had over $2 trillion in assets and paid annual benefits of $122 billion, averaging about $18,500 per retiree.\(^4\) Ninety percent of state and local governmental employees are covered by defined benefit retirement plans.\(^5\) Approximately 25 percent are not covered by Social Security, including close to half of public school teachers and three-quarters of police officers and firefighters.\(^6\)

Since the mid-1990s, legislation has been proposed in several states to replace state and local DB plans with DC plans. Over the last two years, the pace of these proposals has increased, due to downturns in the investment markets and resulting higher contribution rates for many DB plans. Proponents of the change argue that switching to a DC plan would lower the government’s cost of providing retirement benefits, thereby reducing state and local taxes. They also argue that DC plans would benefit public employees by giving them higher benefits through DC plan investment earnings and by making it easier for employees to take their benefits with them when they change jobs.

As this paper shows, it is likely that switching to a DC plan would increase a government’s retirement costs over the short-term, and possibly over the long-term as well. In addition, recent studies indicate that retirement benefits provided through DC plans are, on average, significantly lower than those provided through DB plans. Moreover, while DC plans are useful for providing supplemental, tax-deferred retirement savings, replacing DB plans with DC plans could cause severe, unintended consequences:

- Governments could lose a valuable tool for attracting and retaining qualified employees;
- Public employees could lose a significant amount of retirement income, potentially affecting state and local economies; and
- Legislators could face additional pressure to increase DC retirement benefits and provide additional financial assistance for public sector retirees.

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\(^4\) Ibid. Table 1. Average benefit calculated by the author and rounded to the nearest thousand dollars.


HOW DEFINED BENEFIT PLANS WORK

In a typical DB plan, employers promise to pay retirement benefits based on an employee’s period of service and final average salary. A typical benefit formula for state and local general employees is 2 percent times final average salary times years of service. Under this formula, an employee who works 20 years and retires with a final average salary of $40,000 would earn an annual benefit of $16,000.

Eligibility for the benefit (i.e., vesting) usually requires employees to work for a minimum period of time, typically 5 years. Upon retirement, the benefit is provided as a series of monthly payments over the retiree’s lifetime (and the surviving spouse’s lifetime if this option is selected by the member who, in return, receives a reduced benefit). Most state and local employees are in DB plans that provide cost-of-living adjustments as protection against inflation. In addition, most state and local DB plans provide disability and pre-retirement death benefits.

DB plan benefits are financed by contributions from the employer (and most often from employees as well) and investment income. Employee contributions are usually established at a fixed rate of pay (e.g., 5 percent). Employer contributions are calculated so that, over the long-run (50 years or more), annual contributions plus expected investment earnings are enough to pay the promised benefits plus administrative expenses. The calculations are done by actuaries and designed to maintain employer contribution rates at a level percent of payroll, by smoothing short-term investment fluctuations and using other actuarial techniques. Plan assets are invested in professionally managed, broadly diversified portfolios, with investment fees paid by the plan or employer. Retirement benefits are paid from accumulated contributions and investment earnings.

For employers, a key advantage of DB plans is that investment earnings reduce future employer contributions. In other words, employer and employee contributions generate investment earnings that, in turn, are used to pay benefits that would otherwise have to be paid from future employer contributions. From 1983 through 2002, state and local DB plan investments earned $1.65 trillion, reducing the need for additional employer contributions and taxpayer revenues.

A potential disadvantage of DB plans is that when investment earnings are less than expected, additional employer contributions are required. However, it should be noted that the $1.65 trillion earned by state and local investments over the past 20 years includes investment losses that occurred in 2000 through 2002, as well as in 1987 and 1994.

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7 The “2 percent” portion of this benefit formula is referred to as the “benefit multiplier.” Benefit multipliers vary, depending on occupation and Social Security coverage. According to the NASRA/NCTR 2003 Public Fund Survey, the median benefit multiplier is 1.85 percent for state and local employees covered by Social Security and 2.20 percent for those not covered by Social Security.
8 National Education Association, Characteristics of Large Public Education Pension Plans (Washington, DC: National Education Association, 2004). The 88 statewide plans surveyed cover 9.4 million active workers. Fifty-seven percent of the plans had vesting periods of five years.
9 These smoothing techniques work well when investment fluctuations are moderate and short-lived.
For employees, a key advantage of DB plans is that they provide secure and predictable retirement income over their lifetimes based on pre-retirement earnings. A key disadvantage is that employees who do not remain employed long enough to become vested often lose their DB plan benefits, although employee contributions are usually returned with interest.
HOW DEFINED CONTRIBUTION PLANS WORK

In a DC plan, employers provide employees with individual investment accounts and promise to contribute a certain amount to the accounts (e.g., 4 percent to 8 percent of salary) while the employee is employed. Employees can also contribute to their accounts and decide how the assets are invested, choosing from a number of funds representing major investment categories. Investment management fees are paid from the employee’s account, reducing the funds available to pay benefits. At retirement, the employee’s benefit is paid solely from the contributions and investment earnings that have accumulated in the individual’s account.

For employers, one advantage of DC plans is that the employer’s contribution rate is fixed and unaffected by downturns in investment markets. Moreover, the employer has no financial liability for the employees after they retire, even if the DC accounts are insufficient to provide an adequate retirement benefit. (While this may be an advantage for the employer, it is a disadvantage for taxpayers who may have to pay increased public financial assistance as a result.)

A disadvantage for employers is that DC plans may not be a strong incentive for attracting and retaining qualified employees, especially if competing employers are offering DB plans. Moreover, if employees’ account balances are inadequate to provide retirement benefits when the employees intend to retire, employers can end up with a number of active employees who are not performing at peak productivity (also known as being “retired in place”). Another disadvantage is that, since the employer’s contribution rate is fixed in a DC plan, upturns in the investment markets do not reduce the employer’s contribution rate, as they do in DB plans.

For employees, one advantage of DC plans is that the vesting period is typically shorter than for DB plans. Six months to two years is typical. Moreover, DC accounts are easier to transfer if employees change jobs. A major disadvantage is that DC accounts are subject to investment risk and may not be enough to sustain employees throughout their retirement. Another disadvantage is that a high percentage of employees cash-out and spend some or all of their DC accounts when they change jobs, significantly reducing the amounts available to pay retirement benefits.\(^{11}\)

The remainder of this paper describes the issues and problems involved with replacing DB plans with DC plans.

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\(^{11}\) This is surprising since the cashed-out amounts are subject to income taxes. In many cases they are also subject to a 10% penalty tax on early distributions.
DISADVANTAGE # 1:

SWITCHING TO A DC PLAN IS LIKELY TO COST STATE AND LOCAL GOVERNMENTS MORE OVER THE SHORT-TERM. LONG-TERM COST SAVINGS ARE UNCERTAIN AT BEST.

- **DC plans are costly to establish and maintain.** A DC plan must be designed, vendors must be selected, and its operation must be monitored. In addition, employees must be informed about plan features and available investments. Staff time is spent throughout the process, and the sponsoring government must pay additional legal and consulting fees. If a third-party administrator is not hired to administer the plan, the government must do this as well. Even if a third-party administrator is hired, the government will still have operating costs related to the DC plan, possibly ranging in the millions of dollars. For example, the budget for the State of Florida’s DC plan, established in 2000, totaled $89 million from FY 2001 through FY 2004. This includes $55 million to educate Florida’s 650,000 government employees about the new plan.12

- **Pension benefits currently promised to state and local employees and retirees may not be abandoned. Switching to a DC plan does not reduce accrued DB plan benefits already earned.** Most governmental DB plan benefits are protected by the state’s constitution or statutes that prevent accrued benefits from being reduced. Consequently, switching to a DC plan is usually accomplished by giving current and future employees the option of remaining in the current DB plan or electing to transfer to the new DC plan. For current DB plan members who elect the DC plan, the value of the member’s accrued DB benefit is transferred to the DC plan.

- **When given the option, most employees remain in the DB plan.** In most cases, only a small percent of employees elect to transfer from the DB plan to the DC plan.13 To increase the number of employees who eventually enter the DC plan, a few governments have restricted the DB plan to current employees and have required newly hired employees to join the DC plan.14

- **Even when new hires are required to join the DC plan, long-term cost savings for employers are uncertain and may take many years to realize.** When a DB plan is closed to new hires, it still covers current employees and retirees, and benefits continue to accrue to active employees as a result of service. To the extent plan assets are less than accrued liabilities, unfunded

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12 Information provided by the Pension Protection Coalition, based on an analysis of the Florida Public Employee Optional Retirement Program’s approved budgets and revenue collections. The analysis was done for the Coalition by the law offices of Olson, Hagel & Fishburn, LLP, January 18, 2005. The budgeted amounts exclude investment management fees paid by plan participants. Used with permission.

13 Anya Sostek, “Pension Pendulum,” Governing Magazine, March 2004: 28. Three percent of employees covered by the DB plan elected to join the new DC plan in Florida, 6 percent in Michigan, and 2.5 percent in Ohio.

14 National Association of State Retirement Administrators, “Overview of Plan Types.” Of the 14 state retirement systems discussed in this paper, only two (Michigan and West Virginia) required newly hired employees to join the DC plan. The remaining systems offered DC plans as a voluntary alternative to the DB plan or offered a new plan that combined DB and DC plan features. Available on the NASRA web site (www.nasra.org).
liabilities remain. For DB plans with unfunded liabilities, closing the DB plan to new hires will likely increase the employer's annual required contribution rate. Because new hires are not entering the plan, the cost of funding the liabilities is spread over a declining number of active members,\(^\text{15}\) thereby increasing the employer's contribution rate as a percent of covered payroll. In addition, since a growing portion of plan assets must be used to pay benefits, a growing portion of assets will likely be held in short-term securities, thereby reducing investment returns. For example, the Los Angeles County Employees Retirement Association (LACERA) estimated that the County's DB plan contribution rate would increase by 3.66% if employees hired after July 1, 2007, were required to join a DC plan. This would increase County contributions to the closed DB plan by $206 million in 2008. While the contributions would gradually decline over time, the County would have to wait until 2018 to see any savings in DB plan costs as a result of the change.\(^\text{16}\)

- **In several cases, states have replaced DC plans due to inadequacy of plan benefits or increased costs.**

  - In 1977, the North Dakota Public Employees Retirement System, originally established as a DC plan in 1966, was changed to a DB plan. Reasons given for the change include the need to provide adequate retirement benefits and the need to attract and retain quality employees.\(^\text{17}\)

  - In 2000, the State of Nebraska reviewed its two DC retirement plans for state and county workers and found that between 1983 and 1999 the DC plans' investment returns averaged only 6 percent, compared with 11 percent for the state's DB plans. Recognizing these returns were inadequate to sustain retirement benefits, the state responded by creating a new hybrid plan for state and county workers, combining both DB and DC plan features.\(^\text{18}\)

  - In May 2005, West Virginia passed a bill to allow teachers in the Teacher's Defined Contribution Plan (created in 1991) to transfer into the Teacher's Defined Benefit Retirement Plan. According to the West Virginia Consolidated Retirement Board's actuary, the change would save the State $1.8 billion over the next 30 years, because of lower employer contributions required for the DB plan (4.3 percent of payroll) than for the DC plan (7.5 percent of payroll). House Speaker Bob Kiss said, "It actually costs the state more to fund the newer DC [private accounts] system." State teacher representatives said the change would help prevent teachers from leaving their jobs.\(^\text{19}\)

\(^{15}\) Governmental Accounting Standards Board, Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers* (Norwalk, CT: Governmental Accounting Standards Board, 1994), 7. In situations where a DB plan is closed to new members and unfunded liabilities are amortized as a level percent of projected payroll, projected decreases in active plan members should be included in the calculation.


\(^{17}\) North Dakota Legislative Council, Employee Benefits Program Committee, “Public Employees Retirement Programs – History,” October 1998.

\(^{18}\) Anya Sostek, p. 28.

\(^{19}\) “Pension Bond Will Benefit Taxpayers,” *Charleston Daily Mail*. 
DISADVANTAGE # 2:

Almost all state and local DB plans provide disability and survivor benefits as well as retirement income. Switching to a DC plan would require employers to obtain these benefits from another source, probably at a higher cost.

• Almost all state and local DB plans provide disability and survivor benefits. According to the U.S. Bureau of Labor Statistics, 97 percent of state and local government employees in DB plans have disability coverage through the plan and 93 percent may elect joint and survivor benefits.20 These benefits are largely funded through contributions and investment earnings. Disability and survivor benefits are especially important for employees in hazardous occupations such as firefighters and police officers who may die or become disabled in the line of duty.

• Few DC plans provide disability benefits. Moreover, DC plan survivor benefits are limited to the participant’s account balance. In the absence of a DB plan, employers would need to obtain disability and pre-retirement death benefits through commercial insurance or else would have to self-fund the benefits. Either of these options would result in additional administrative costs. If the benefits were obtained through commercial insurance, the employer’s cost would also include the insurer’s profit margin.

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DISADVANTAGE # 3:

DB PLANS ENHANCE THE ABILITY OF STATE AND LOCAL GOVERNMENTS TO ATTRACT QUALIFIED EMPLOYEES AND RETAIN THEM THROUGHOUT THEIR CAREERS. SWITCHING TO A DC PLAN WOULD LIMIT THIS ABILITY, POSSIBLY PRODUCING OR EXACERBATING LABOR SHORTAGES IN KEY SERVICE AREAS BY INCREASING EMPLOYEE TURNOVER RATES. HIGHER TURNOVER RATES RESULT IN INCREASED TRAINING COSTS AND LOWER LEVELS OF PRODUCTIVITY THAT CAN, IN TURN, RESULT IN THE NEED FOR A LARGER TOTAL WORKFORCE.

- Employers offer retirement plans as a way to attract qualified employees and retain them so their skills and experience are used efficiently. According to the Diversified Investment Advisors’ Report on Retirement Plans, most large employers see a tangible value in offering a defined benefit plan to their employees – despite the high costs sometimes associated with it. Fifty-eight percent of plan sponsors with 25,000 or more employees believe that their DB plans have a major impact on employee retention.21

- DB plan provisions encourage employees to remain with an employer longer than DC plan provisions. The vesting period for DB plans is typically longer (e.g., 5 years) than the vesting period for DC plans (e.g., 6 months to 2 years). Consequently, employees have a financial incentive to continue working for the employer at least until they vest. After that, benefit accruals based on continued service provide an additional financial incentive.

- Key governmental service areas, such as education and public safety, require skilled and dedicated employees to work in positions involving high levels of stress or physical activity or both. Individuals with the skills and temperament to take on these roles usually have other opportunities in the labor market. DB plans provide strong incentives by rewarding long-term, dedicated service with a secure retirement.

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DISADVANTAGE # 4:

DB PLANS HELP STATE AND LOCAL GOVERNMENTS MANAGE THEIR LABOR FORCE BY PROVIDING FLEXIBLE INCENTIVES THAT ENCOURAGE EMPLOYEES TO WORK LONGER OR RETIRE EARLIER, DEPENDING ON THE CIRCUMSTANCES. SWITCHING TO A DC PLAN WOULD LIMIT THIS FLEXIBILITY AND MAKE THESE INCENTIVES MORE EXPENSIVE FOR THE EMPLOYER.

- Governments can use DB plan benefits as a way to manage their labor force by rewarding longer employment or encouraging retirement after a certain period employment. DB plan benefit formulas can be structured to provide incentives for longer employment by increasing the benefit multiplier after a certain period of service. For example, the formula could provide benefits of 2.0 percent of final average earnings for the first 20 years of service and 2.2 percent for service over 20 years. To encourage retirement after a certain period of employment, DB benefit formulas can limit benefit accruals to a maximum percent of final average earnings or a maximum years of service. In the above example, if the benefit accrual was limited to 62 percent of final average earnings, it would encourage employees to retire after 30 years of service. Other options, such as early retirement incentives (ERIs) and deferred retirement option plans (DROPs), are also available.
DISADVANTAGE # 5:

DB PLANS LOWER OVERALL RETIREMENT BENEFIT COSTS BY POOLING THE RISKS OF OUTLIVING RETIREMENT BENEFITS AND OF INVESTMENT LOSSES OVER A RELATIVELY LARGE NUMBER OF PARTICIPANTS. SWITCHING TO A DC PLAN WOULD REQUIRE EACH INDIVIDUAL TO BEAR THESE RISKS ALONE, CONSEQUENTLY REQUIRING HIGHER CONTRIBUTIONS THAN IF THE RISKS WERE POOLED.

- DC plan participants must save enough to ensure they will not outlive their benefits while protecting their funds against financial market fluctuations. Average life expectancy at age 65 is 16 years for men (age 81) and 19 years for women (age 84).\footnote{U.S. Department of Health and Human Services, Social Security Administration, 2004 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Trust Funds (Washington, DC: U.S. Government Printing Office, 2004), p. 81.} Furthermore, 71,000 people will be 100 years or older in 2005, and 1.9 million will be 85 or older.\footnote{U.S. Department of Commerce, U.S. Census Bureau, Statistical Abstract of the United States 2004-2005 (Washington, DC: U.S. Government Printing Office, 2004), Table No. 12.} This means that DC plan participants must contribute enough to ensure their benefits will be paid through their maximum life expectancy, i.e., at least until their late 90s.

- In order to lower investment risk, DC plan participants usually shift a greater portion of their assets from stocks into bonds as they grow older. While this helps protect against equity market downturns, it also lowers likely investment return. According to a recent Employee Benefit Research Institute study, 401(k) plan participants in their 20s invest 65 percent of their account balances in equities (including company stock) and 21 percent in fixed-income securities, on average. Participants in their 60s invest 49 percent in equities and 40 percent in fixed-income securities.\footnote{Sara Holden and Jack VanDerhei, “401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2004,” EBRI Issue Brief, No. 272, August 2004. Employee Benefit Research Institute.} In contrast, large public retirement systems hold 57 percent of assets in equities, 32 percent in fixed-income securities, and the remaining 11 percent in other investments.\footnote{Keith Brainard, “Public Fund Survey, Summary of Findings, FY 2003,” September 2004.}

- By averaging risks over a large number of participants, DB plans lower the total costs of providing retirement benefits. Instead of requiring contributions that are large enough to fund retirement benefits through maximum life expectancy, DB plans only need to fund benefits through the average life expectancy of the group. This lowers required contributions. Moreover, by spreading investment risk over a longer period, DB plans can maintain an investment mix that includes a higher percentage of equity investments. This increases likely investment returns, which further lower required contributions.
DISADVANTAGE # 6:

DB PLANS EARN HIGHER INVESTMENT RETURNS AND PAY LOWER INVESTMENT MANAGEMENT FEES, ON AVERAGE, THAN DC PLANS. SWITCHING TO A DC PLAN IS LIKELY TO LOWER INVESTMENT EARNINGS USED TO FINANCE RETIREMENT BENEFITS AND INCREASE MANAGEMENT COSTS, TO THE DETRIMENT OF PLAN MEMBERS.

- Employees direct their own investments in a DC plan, usually selecting from among several funds that reflect major investment categories. Generally, employees have limited investment experience or training. In a DB plan, investments are selected and monitored by investment professionals who have extensive experience and training.

- On average, investment returns for DC plans are lower than for DB plans, resulting in significantly lower investment earnings over an individual’s lifetime. According to Boston College economist Alicia Munnell, DB plans outperformed DC plans by 0.8 percent annually, on average, between 1985 and 2001.26 For a person contributing $5,000 to a DC plan each year for 40 years, the difference between an 8.0 percent annual return and a 7.2 percent return amounts to a loss of over $244,000 in retirement benefits.27 Other surveys show that individual, non-professional investors may underperform the market by as much as 2.0 percent annually.28 In the above example, the difference between an 8.0 annual return and a 6.0 percent return amounts to a loss of over $521,000 in retirement benefits.29

- Administration and investment costs for DC plans can be more than four times higher than for DB plans. In DC plans, these costs are borne directly by individual plan participants through deductions from their DC accounts. According to the Investment Management Institute, the operating expense ratio for DB plans averages 31 basis points (31 cents per $100 of assets) compared with 96 to 175 basis points for DC plans.30 According to the Illinois Municipal Retirement Fund, the total annual administrative and investment cost for their DB plan amounted to 44 basis points in 1999. If they had switched to a DC plan, total annual administrative and investment costs could have increased up to 225 basis points, or up to $250 million more than the annual administrative and investment costs paid by the DB plan.31

27 Author’s calculations.
29 Author’s calculations.
DC plan participants often cash-out and spend some (or all) of their DC accounts when they switch jobs. As a result, the accounts contain less money to earn investment returns and to pay benefits at retirement. According to Alicia Munnell, more than half of DC plan participants withdraw funds from their DC accounts when they change jobs, removing between one-quarter and one-third of total DC plan assets before they reached retirement.\textsuperscript{32}

\begin{footnotesize}\textsuperscript{32} Munnell and Sunden, p. 132.\end{footnotesize}
DISADVANTAGE # 7:

DB PLAN INVESTMENT EARNINGS REDUCE FUTURE EMPLOYER CONTRIBUTIONS. SWITCHING TO A DC PLAN WOULD PREVENT STATE AND LOCAL GOVERNMENTS FROM REDUCING EMPLOYER CONTRIBUTIONS THROUGH INVESTMENT EARNINGS, WHICH CURRENTLY FUND OVER TWO-THIRDS OF PUBLIC RETIREMENT BENEFITS.

- State and local governments have benefited from investment returns overall and many have used investment earnings to reduce employer contributions. Over the long-term, an employer’s cost of providing DB plan benefits depends on investment earnings. Although investment earnings can fluctuate sharply at times (as happened between 2000 and 2002), over the last 20 years state and local governments have benefited from investment returns and have used the accumulated assets to lower employer contributions. As provided in governmental accounting standards, plan assets that are greater than plan liabilities are amortized to reduce employer contributions. A 2002 survey of Michigan state and local government retirement systems shows that of 115 independent local government retirement plans surveyed, employer contributions for 102 (89 percent) were below the normal cost of benefits as a result of this amortization.

- Most of the money paid out of state and local retirement plans comes from investment earnings. Over the last 20 years, state and local government investment earnings amounted to about $1.65 trillion, compared with total employer contributions of $696 billion. This means two out of every three dollars paid from state and local retirement plans was received from investment earnings. According to a paper on state and local retirement plans prepared for the Wharton School’s Pension Research Council: “Setting aside all the other benefits to employers and employees of DB plans, contributions to public pension plans may be among the best investments a state or local government can make.”

Look at the facts:

- Employer (taxpayer) Contributions = 26%
- Employee Contributions = 12%
- Investment Earnings = 62%

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33 Governmental Accounting Standards Board, Statement No. 27, p. 6.
36 Anderson and Brainard, p. 14.
DISADVANTAGE # 8:

DB PLANS PROVIDE SECURE RETIREMENT BENEFITS BASED ON A PERSON’S SALARY AND PERIOD OF SERVICE. SWITCHING TO A DC PLAN IS LIKELY TO RESULT IN LOWER AND LESS SECURE RETIREMENT BENEFITS FOR MANY LONG-TERM GOVERNMENTAL EMPLOYEES, INCLUDING TEACHERS, POLICE OFFICERS, AND FIREFIGHTERS, WHO CONSTITUTE OVER HALF OF STATE AND LOCAL GOVERNMENT WORKERS. STATE AND LOCAL EMPLOYEES WHO ARE WITHOUT SOCIAL SECURITY COVERAGE WOULD BE PUT AT EVEN GREATER RISK.

- Retirement benefits paid from DC plans are significantly less than those paid from DB plans. The U.S. Congressional Research Service found that, for current older workers, DC-type plans will provide annual benefits of less than $5,000 for half the workers. This is less than one-third of the $18,000 average annual benefits currently paid by governmental DB plans to state and local workers.

- If average state and local retirement benefits fell from $18,000 to $5,000, it would mean a loss of about $80 billion in annual personal income. This loss would be felt by state and local economies, since many retirees remain in the same location when they retire. These pension benefits are also, in most cases, subject to federal and state income taxes, thus resulting in a loss of tax revenues. The same would be true in states that rely solely on sales taxes as their source of revenue.

- The change would have an even greater effect on the 25 percent of state and local government employees who are not covered by Social Security, including about half of school teachers and three-quarters of police officers and firefighters. When first enacted in 1935, Social Security excluded state and local employees, due to constitutional questions about the federal government’s right to tax state and local governments. In 1950, Congress amended Social Security to allow state and local governments to voluntarily elect coverage. By then, however, half of the largest state and local plans had already been established, including many plans for teachers and public safety employees. These DB plans provide benefits that compensate for the lack of Social Security coverage. Replacing them with defined contribution plans would put members at even greater risk, since they would not have Social Security benefits to fall back on.

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38 Based on $110 billion in state and local annual benefit payments made in 2002.
DISADVANTAGE # 9:

DB PLANS HELP SUSTAIN STATE AND LOCAL ECONOMIES BY PROVIDING ADEQUATE RETIREMENT BENEFITS FOR A SIGNIFICANT PORTION OF THE WORKFORCE. SWITCHING TO A DC PLAN MAY SLOW STATE AND LOCAL ECONOMIES, SINCE A LARGE NUMBER OF RETIREES WOULD LIKELY RECEIVE LOWER RETIREMENT BENEFITS.

- The economic value added by the investment income of state and local DB plans over what would otherwise have been earned in DC plans is estimated to be about $200 billion annually, or 2.0 percent of U.S. Gross Domestic Product.\(^{40}\) In essence, state and local retirement plans act as financial engines, using employer and employee contributions to generate investment income that, when paid as retirement benefits, bolsters state and local economies by $200 billion a year. State and local retirees purchase a wide range of goods and services with their retirement income. These purchases, in turn, promote employment and create additional economic demand, generating additional economic activity. As a result of this multiplier effect, the economic activity generated by the higher investment earnings amounts to 2.0 percent of U.S. Gross Domestic Product. As a growing number of state and local employees retire, this percentage will likely increase.

\(^{40}\) Anderson and Brainard, p. 14.
DISADVATAGE # 10:

SWITCHING TO A DC PLAN IS LIKELY TO RESULT IN PRESSURE ON STATE AND LOCAL GOVERNMENTS TO INCREASE DC PLAN BENEFITS AND PROVIDE ADDITIONAL FINANCIAL ASSISTANCE FOR PUBLIC SECTOR RETIREES.

- If DC plan benefits are less than what is needed to ensure an adequate standard of living during retirement, continued pressure will be placed on state and local governments, legislators, and taxpayers as retirees outlive their retirement income. Since DC benefits are not indexed to inflation, extended periods of even modest inflation will mean almost constant pressure for some form of additional financial support for retirees, who will make up a growing portion of the electorate. When DC plan benefit improvements are granted, they will be paid from current government revenues and will not be offset by investment earnings.
CONCLUSION

This paper addresses the question, “Should state and local government defined benefit plans be eliminated and replaced with defined contribution plans?” It concludes that such a move would have significant, long-term, detrimental effects on state and local governments, their employees, their economies, and ultimately the taxpayers.

In the final analysis, the real question is, “How can state and local governments efficiently provide secure and adequate retirement benefits to their employees?” To answer this question, retirement benefits should be viewed in total, including benefits from Social Security, defined benefit plans, defined contribution plans, and individual savings. No single source alone is sufficient, but together they can be used to provide effective and efficiently funded retirement income. Excluding defined benefit plans will only intensify future problems rather than help provide solutions.

Neither market fluctuations nor increased employer contributions should be the driving force for changing the structure of the pension benefits. Instead, decisions should be based on a clear understanding of what outcomes the current design creates and whom it rewards. Retirement plan design represents a significant public policy. Therefore, the plan sponsor contemplating change must understand the policy implications of any new proposal as well as those of the current retirement plan design.

Successful plan changes happen when plan sponsors analyze their current plan and define any problems they discover. When considering such changes, plan sponsors should review several possible actions:

- Survey active and retired members of the current retirement plan.
- Measure the satisfaction and confidence of those members.
- Understand the needs of retirement system employers.
- Understand comparative private sector plans and their goals.
- Adopt a formal policy for the retirement system plan design reflecting the plan sponsor's goals and those of the active and retired members.

Dramatic change is never the answer!

Rather, with the proper analysis and an understanding of the needs of a changing population, fine-tuning of the basic pension plan design can produce excellent results and flexibility for all -- the sponsors, employees, retirees, and the taxpayers.