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Defined Benefit Retirement Plans:

A Proven System

“Defined benefit pensions, if properly structured and managed, can serve the interests of all stakeholders—taxpayers, employers and employees.”

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“Defined benefit” retirement plans for public workers are good for taxpayers

A major component of proposals for pension reform by fiscal conservatives is converting the state employee pension system from a “defined benefit” plan to a “defined contribution” plan¹. Defined-contribution (DC) supporters argue that such plans save employers money when stock prices are falling, but they are actually less efficient and more costly than defined benefit (DB) plans and they significantly increase the risk of poverty among the elderly, and would fail to attract good workers to state service.

This report shows that converting California’s state retirement system from a DB plan to a DC plan for state employees is a bad option for state taxpayers as well as for state employees.

Defined-benefits plans offer more value at lower costs

DB plans provide greater benefits to retirees at a lower cost to the employer. This is true because a DB plan administers one large pool of money, while DC plans require oversight over thousands of individual accounts. A DB plan must take greater care in administering a giant nest egg, but it is still more economical than tracking individual investments of all current and retired state employees.

DB plans also more efficiently provide for retirees’ future security. Investment experts recommend that individuals shift into lower-returning, less-volatile investments as they age, minimizing losses should the stock market fall suddenly just as they retire.² However, a DB plan can invest a higher proportion in high-return stocks because the investments are pooled and not tied to any individual’s life cycle. When the state of Nebraska offered both a DC plan and DB plan, returns on the DB plan were nearly double those from the DC plan (11% vs. 6%)³.

Overall, the National Institute on Retirement Security estimates that, considering administrative costs, investment returns, and other factors, DB plans cost slightly less than half as much as DC plans, producing a 46 per cent savings for taxpayers⁴.

“When the state of Nebraska ran a DC plan and DB plan at the same time, the DB plan had a return that was nearly double that of the DC plan.”

DEFINITIONS: Under a “DB” plan, an employer promises its employees to pay a given monthly dollar amount after retirement if the employee meets certain qualifications (reaches a certain age, is with the company for a certain number of years, etc.). The employer (and in the case of state workers, the employees) contribute money into a fund that is invested, and the promised payments are made from a combination of employer and employee contributions and the return on the fund’s investments.

Under a “DC” plan, an employer makes a monthly contribution to a fund specifically designated for the individual employee (who can also contribute), and usually the employee has some control over how the funds are invested; the employee then can withdraw from the fund upon retirement. The employee does not collect a predetermined amount per month but instead draws from whatever is in the fund at the time of retirement. In the private sector DC plans are often known by their designation in the IRS Code, 401(k) plans.

DB plans protect against impoverished retirement

Perhaps a DB plan’s biggest advantage for employees is not the amount of the retirement payments but the certainty of them. Workers planning their retirement face a number of uncertainties, from life expectancy to future inflation to uncertain returns on investments. With a DB plan’s assured monthly payments, employees can more securely plan on supporting themselves when they retire.⁵

Those in a DC program are more susceptible to poverty if circumstances go awry. A dramatic meltdown in the stock market just before retirement could deplete an employee’s retirement nest egg. Once retired and unable to earn the money back or rely on other options, retired employees could slip into poverty.

It doesn’t take a monumental market shock like the one in 2009 to drain DC plans of adequate funds. Though DC plans generally have lower returns than DB plans as a result of lifecycle investing, DC plans also yield lower returns because amateur investors tend to be more timid than professionals who understand risk management and portfolio diversity⁶. Consistently under-performing investments over the life of a retirement fund can result in inadequate savings upon retirement, leading to an old age spent in poverty⁷.

Ideally, retirement income is a “three-legged stool” comprised of Social Security, an employer-provided pension and personal savings. When the pension “leg” comes up short, retirees are forced to depend on government assistance, creating additional expense for taxpayers⁸.

DB plans attract quality employees

One of the most common arguments for switching public sector employees from a DB plan to a DC plan is that the private sector has already largely made the switch. However, even though DB plans are not as prevalent as they once were in the private sector, many large firms, including Fortune 500 ones, still offer DB plans⁹.

According to data from the 2008 U.S. Census, about one-third (33%) of medium and large firms continue to offer DB pensions. More than half (55%) offer a DC plan, sometimes in combination with the DB plan. Only 9 per cent of small firms offer DB plans, primarily because small employers cannot manage risks involved in a DB plan. But large firms and entities such as the state of California can. Among state and local governments, 79% have DB plans¹⁰.

Because the public sector still offers attractive pension plans, qualified employees opt to work for lower pay in the public sector over private industry.¹¹ Taking into account education and experience, public employees earn less than their private sector counterparts.¹² One of the few advantages that a public employer like the state has over private ones, especially small private firms, is the preferred DB plan.

Advocates of DC plans contend that modern workers prefer the mobility and control of a DC plan. Though some workers who change jobs frequently might prefer a DC plan that can follow them, employees in the public sector still opt for DB plans. In states where new hires could choose between either plan, or a plan that combined the two, the overwhelming majority selected a DB plan. In one study of seven states that offered employees a choice, DC plans as first choice exceeded 20 percent in only one state. The range of those preferring defined contributions was 3 per cent in Ohio to 26 per cent in Florida.¹³

“In states where new hires were offered an option between a DB plan or a DC plan, the overwhelming majority chose a DB plan.”

EMPLOYERS WITH DEFINED BENEFITS PLANS

Size of Employer	% with DB Plan	Year
Fortune 500	73.4%	2006
Medium & Large Private Firms	33.0%	2008
Small Private Firms	9.0%	2008
State & Local Governments	79.0%	2008

But are DB plans sustainable?

Critics of DB plans claim that DB plans are about to either run out of money or usurp an exorbitant share of the budget because of the recent stock market decline. Those opponents fail to recognize that DB plans manage their assets over a long period of time, navigating and surviving stock market fluctuations. DB plans always appear bleakly under-funded right after a significant downturn in the stock market depletes their assets, just as they always appear flush in a booming market like in the late 1990’s.

Public retirement systems must comply with reporting requirements established by the Government Accounting Standards Boards (GASB), which assures transparency of the funds’ finances. The financial status of any DB plan is open for evaluation and any anticipated problems can be addressed years in advance. In California, CalPERS has minimized immediate effects from the recent stock market drop by phasing the losses over three years, and by providing separate rules for paying off the losses over 30 years.¹⁴ Only a DB plan can take such sweeping steps to ensure long-term stability after a major shock; those older workers and retirees relying on 401K’s when the stock market fell, are now in the workforce – if they’re lucky – with no end in sight.

Conclusion

A DB pension plan is not only good for state employees, but beneficial for taxpayers. DB plans are cheaper to administer than DC plans, provide more benefits at a lower cost, decrease the chances of retirees being forced onto public assistance, and attract high-quality workers to the state.

The clamor to reform the state’s pension system by switching to defined compensation ignores significant financial advantages embodied in defined benefits. Before making a regrettable change that will profoundly implicate thousands of future retirees and their families, policy makers should remember the proven success of California’s DB pension system--the California Public Employee Retirement System—for lowering costs and providing income security for almost 70 years.

End Notes

- 1 See, for example, Governor Schwarzenegger's 2005 State of the State address in which he said, "Accordingly, we must do what business has been doing. For new employees, we must move from a DB to a DC system." Full text of the speech is at <http://gov.ca.gov/speech/2408>.
- 2 For example, the website CNNMoney.com recites the general formula that your retirement portfolio's share of stocks should be equal to 110 (or 120) minus your age, so that as you get older the proportion of your portfolio invested in bonds increases. <http://money.cnn.com/retirement/guide/investing-basics.moneymag/index7.htm>.
- 3 California Retired Teachers Association, except from Feb. 3, 2005 report, <http://calrta.org/get-informed/our-issues/background-information/defined-benefit-vs-defined-contribution-pensions/>. For more on the Nebraska experience see the report from the Utah Retirement System "Defined Benefit Plans (DB) vs. Defined Contribution Plans (DC)" at http://www.urs.org/general/pdf/db_vs_.pdf and "Why One State Ditched Public Pension Switch," Dale Kasler, Sacramento Bee, January 30, 2005, at <http://www.dsasd.org/pensions/pdfs/nebraska.pdf>.
- 4 Beth Almeida and William B. Forna, FSA, "A Better Bang For the Buck," *Journal of Pension Benefits*, Vol. 16, No. 2 inter 2009 pp. 11-15, accessible at <http://www.nirsonline.org/storage/nirs/documents/Bang%20for%20the%20Buck%20Report.pdf>.
- 5 Frank Porell, Ph.D. and Beth Almeida, *The Pension Factor*, National Institute on Retirement Security, July 2009, at http://www.nirsonline.org/storage/nirs/documents/pension_factor_web.pdf.
- 6 Mark Offerman, FSA, MAAA, "Public Plan DB/ Choices." *PERiScope* January 2009 at http://www.nasra.org/resources/Milliman_DB_Choice.pdf, p.3.
- 7 Of course a DB plan must provide high enough benefits for the recipient to avoid poverty. Before benefits for state employees were increased in 1999, the average non-teaching CalPERS retiree received a monthly amount of \$922, which was exactly equal to the poverty rate for a family of two. Ed Mendel, "Pension Reform: Can Arnold Lift SB 400?" *Calpensions*, <http://calpensions.com/2010/07/16/pension-reform-can-arnold-lift-sb-400/>.
- 8 Porell & Almeida estimate that DB pension plans help 4.7 million Americans avoid poverty, and help keep 1.4 million Americans off public assistance, at pp. 14-17.
- 9 According to one source, in 2006 367 of the Fortune 500 companies still had some form of DB program. Peggy J. Crawford, Edward H. Fredericks, "Insured Pension Funds—Who Benefits?" *Journal of Business and Economics Research*, Vol. 5 No. 10, October 2007, at <http://www.cluteinstitute-onlinejournals.com/PDFs/334.pdf>.
- 10 Employee Benefit Research Institute, *EBRI Databook on Employee Benefits*, Chapter 10, <http://www.ebri.org/pdf/publications/books/databook/DB.Chapter%2010.pdf>, pages 2-5,
- 11 Keith A. Bender and John S. Heywood, "Out of Balance: Comparing Public and Private Sector Compensation Over 20 Years," National Institute on Retirement Security, April 2010, at http://www.nirsonline.org/storage/nirs/documents/final_out_of_balance_report_april_2010.pdf
- 12 Bender & Heywood, p. 14-15. See also Beth Almeida, "DB Pensions: The Real Deal," *Journal of Pension Benefits*, July 2010 p. 5.
- 13 Offerman, p. 1-2.
- 14 "A second change adopted last year phases in rate increases from losses during the 2008 market crash over three years. It briefly expands the corridor to 40 percent and treats market-crash losses separately, paying them off over 30 years." From "SB 400 Pension Boost: Uncanny Forecast Unheeded" by Ed Mendel, *Calpensions* blog, July 27, 2010, <http://calpensions.com/2010/07/27/sb400-pension-boost-uncanny-forecast-unheeded/>. The final version of these changes was adopted by CalPERS Board of Administration on December 16, 2009. <http://www.calpers.ca.gov/eip-docs/about/boards-cal-agenda/agendas/full/201002/item03.pdf>, agenda item #15.