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## Myths and Misperceptions

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Policymakers, public pension plan administrators and others with a political or financial interest are engaged in a debate about the retirement benefits that are provided to public employees. Considering that state and local government pension plans provide benefits for 14 million active employees and hold assets of $2 trillion, the consequences of this discussion are far-reaching.

Ninety percent of state and local government employees participate in a defined benefit (DB) pension plan. A movement has unfolded in recent years calling for defined contribution (DC) plans to replace DB plans as the primary retirement benefit for public employees. A number of myths and misperceptions surround this movement; through this paper, NASRA seeks to address and clarify some of the more popular misunderstandings and misrepresentations about these plan types.

Financial planners have long referred to an ideal mix of retirement income sources as a “three-legged stool,” with one leg each representing Social Security, personal savings, and an employer pension. Although not every worker attains it, a well-balanced three-legged stool is a sensible personal financial planning strategy; an important component of an employer’s benefits package; and a sound public policy objective. Without an employer pension, there can be no three-legged stool. (In states that do not participate in Social Security, pension benefits for public employees typically are adjusted upward to compensate for the absence of Social Security benefits.)

Most public employers offer a voluntary DC plan, such as a 457 or 403(b) that supplements the DB plan. These types of DC plans, which function like a 401(k) plan, are tax-deferred and can fulfill the personal savings piece of the three-legged stool.

NASRA believes that a DB plan should constitute an employee’s basic retirement plan, and should be supplemented by a voluntary DC plan. A 1998 NASRA resolution said, in part:

“… NASRA supports the prevailing system of retirement benefits in the public sector, namely, a defined benefit program to provide a guaranteed benefit and a voluntary defined contribution plan to serve as a means for employees to supplement their retirement savings; … NASRA supports progressive changes within this prevailing system of retirement benefits in the public sector, either within the defined benefit plan or through supplementary plans, that accommodate a changing workforce and better provide many of the features sought by advocates of wholesale conversion.

Policymakers, taxpayers, and others with an interest in public employee benefits are well-served when the discussion about DB and DC plans is based on facts and a clear understanding of these plan types and the way they function.
Summary
Defined benefit (DB) and defined contribution (DC) plans each offer their own advantages and disadvantages. NASRA believes that employers should take advantage of both plan types by offering a DB plan as the primary retirement benefit, supplemented by an optional DC plan.

The implication that government should follow the lead of the private sector in adopting DC plans overlooks important differences between private and public DB plans and the reasons that some private sector plan sponsors have adopted DC plans. This implication also ignores the resilience DB plans have exhibited among many private sector employers.

Analysis
A closer examination of the private sector trend toward DC plans reveals not only that the extent of this trend is not as great as implied by many advocates of DC plans, but also that many of the factors driving the change toward DC plans are largely irrelevant to the public sector. For example:

- State and local government pension plans are exempt from most of the laws and regulations, known as ERISA, that govern private sector DB plans. ERISA imposes a substantial cost and administrative burden on employers that sponsor a DB plan, and accounts for much of the private sector movement toward DC plans.
- Virtually all the decline in the number of private sector DB plans has occurred among small employers – those with fewer than 250 employees. A majority of large private sector employers continues to offer a DB plan. This is likely attributable to the economy of scale large employers enjoy, enabling them to incur the cost and burden of providing a DB plan; and to the relative ease and low cost of establishing a DC plan.

There are good reasons for employers to retain a DB plan as the primary retirement benefit for public employees:

- A DB plan is an effective tool for recruiting and retaining quality employees. Government’s exemption from most federal pension laws creates a rare competitive advantage for state and local government employers.
- Providing a DB plan helps assure a secure source of income for retired employees, reducing the likelihood of these employees relying on public assistance during retirement.
- By creating an incentive to retire, DB plans can facilitate an orderly transition of employees whose effectiveness or productivity may have waned. DC plans provide no such incentive, and may, in fact, serve as a disincentive.

Legal and Regulatory Changes
Analysts attribute much of the increase in the number of DC plans in private industry to ERISA, the Employee Retirement Income Security Act, which became effective in 1975. ERISA established standards for DB plan participation, vesting, retirement, and reporting; and imposed a tax on DB plans to fund the Pension Benefit Guaranty Corporation (PBGC). State and local government pension plans are not subject to
most ERISA regulations, and public plans are not required to make payments to the PBGC. As a result, the primary factor—ERISA—driving the private sector toward DC plans does not apply to state and local government plans. In lieu of ERISA, public pension plan sponsors (state and local governments) establish their own governing standards and rules. One beneficial outcome of this arrangement has been a wide range of policies and benefit structures, each suited to the unique needs of their plan sponsors.

ERISA amendments, particularly the Multiemployer Pension Plan Amendments Act of 1980, the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1986 – reduced or eliminated incentives to private sector employers offering DB plans, and increased the liability, expense, or regulatory requirements of maintaining a private sector DB plan. The rate of decline in the number of private sector DB plans was considerably more pronounced in the years immediately following these tax law changes, than it has been since.

Evidence suggests that recent legislative changes are encouraging a return of DB plans to smaller private sector businesses. According to Plan Sponsor, starting in the late 1990’s, Congress relaxed some restrictions on DB plans. For example, in 1999, Congress eliminated contribution limits under section 415(e) of the tax code, which had restricted tax-deferred contributions and pension accruals for pension participants when a plan sponsor offers both a DB and a DC plan.

Large vs. Small Employers
Enactment of ERISA and subsequent amendments have especially affected smaller employers, which is where the vast majority of the reduction in DB plans has taken place. But most large employers continue to use DB plans. 346 of the S&P 500 offer DB plans as their primary retirement plan. A recent Watson Wyatt analysis of Fortune 100 companies, which are many of the nation’s largest employers, found:

- 50 percent provide a DB plan as their primary retirement plan option; of these, most offer a supplementary 401(k) plan.
- One-third offer a “hybrid” plan, which combines elements of DB and DC plans.
- Only 17% offer a DC plan as their primary retirement benefit.

This survey also found that during the two-year period 2000-2001, the trend away from DB plans virtually stopped, and the number of companies offering a DC plan as the primary retirement benefit held steady. This trend is consistent with other studies indicating that most of the reduction in private sector DC plans during the past 25 years took place among smaller employers, and in the wake of the enactment of ERISA and subsequent amendments.

The Watson Wyatt survey also is consistent with the findings of an EBRI study that found that since 1985, the number of employers with 10,000 or more employees offering a DB as their primary retirement plan has actually increased. That this increase has taken place during a period of many corporate mergers of large firms (which reduces the total number of employers in this category) makes it even more notable.

Most public sector employees work for governmental entities that are large

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employers, and government as an employer should be compared with large private employers. A majority of these employers continue to offer DB plans to their employees. While many factors determine the type of retirement benefit an employer provides, these large private employers recognize the important role a DB plan plays in attracting and retaining quality employees.

As an employer, government has an opportunity to directly affect the retirement income security of its employees and to exploit one of the few competitive advantages government enjoys over private sector employers. Providing a benefit that assures workers a level of retirement income that is consistent with their tenure and salary is an effective way to exploit this advantage.
The Myth: “DC plans are better because they offer greater portability than DB plans.”

Summary
DC plans do offer greater portability than DB plans. Unfortunately, this often leads to less retirement income security, not more.

Studies and experience show that a majority of terminating employees with a DC plan as their primary retirement benefit, cash out their assets rather than rolling them to another retirement plan. Retirement assets that are cashed out usually are subject to federal and state taxes and sometimes a penalty. Cashing out retirement assets defeats the purpose of having a retirement plan, yet DC plans provide little defense against such “leakage” of retirement assets.

An important objective of providing a retirement benefit is to retain quality employees. DC plans do not support this objective because they do not reward or encourage longevity. Because DB plans do reward longevity, they are an important element in retaining quality employees.

Analysis
Rather than make a wholesale conversion from a DB to a DC plan, many DB plan sponsors have responded to the needs of short-term, mobile, and other employees seeking portability, by providing a voluntary, supplemental DC plan option and by increasing the portability features of their DB plan. In fact, DB plan sponsors have incorporated a remarkable range and variety of innovative portability features, while preserving the core features of a DB plan. In doing so, DB plan sponsors provide a retirement benefit that offers the best features of both plan types.

Following are some examples of the flexibility and portability that state and local pension plans have added to DB plans during the past decade:

- Reduced vesting periods
- Paying to terminating or retiring employees all or part of the employer’s contributions
- Paying interest on distributed employee and employer contributions
- Sharing investment gains with participants
- Matching employees’ contributions to a supplemental DC plan
- Adding alternatives to the traditional life annuity payment options made to terminating and retiring employees
- Allowing hardship withdrawals
- Allowing members receiving a pension to continue working or to return to work
- Service purchase options that feature:
  - a variety of types of service for which credit may be purchased (e.g., other public service, service only in the same state, non-public service, etc.)
  - purchase of service using pre-tax dollars
  - availability of installment payments and automatic payroll deduction to purchase service
  - direct transfers of service credit from one retirement plan to another, in lieu of payments
  - allowing other retirement assets, such as those in 457 and 403(b) plans, to purchase service on a pre-tax basis
- Establishing and expanding deferred retirement option plans (DROP), that
allow members who qualify for retirement to continue working while accumulating assets in a separate retirement account

- Incorporating a “deferred augmentation” feature, which grows pension benefits for participants who terminate prior to reaching retirement eligibility.

**Reduced vesting periods**

One concern DC advocates have cited about the lack of portability in DB plans is their long vesting period. Ten years ago, a majority of public pension plans had a vesting period of ten years. This has changed: one of the more notable trends among public DB plans during the last decade has been the reduction in vesting periods.

According to the Wisconsin Retirement Research Committee’s 2000 Comparative Study of Public Retirement Systems, a biannual survey that compares features of 85 of the largest public pension plans in the United States, “[t]he trend appears to be toward five-year vesting or shorter, perhaps reflecting federal [ERISA] vesting requirements that apply to private pension plans.” Including changes made since publication of the Wisconsin report, 58 of the study’s 85 plans (68%) have vesting periods of five years or less.

**Service purchase options**

Service purchase provisions accommodate workers who move from one employer to another, or who terminate and “cash out” their assets, then return to work with the same employer or one with the same retirement plan. A service purchase plan allows these employees to purchase retirement service credits in their DB plan.

The expansion of service purchase provisions has been a leading legislative trend affecting public pension plans during the past decade. More than two-thirds of the plans participating in the 2001 Public Pension Coordinating Council (PPCC) Survey of State and Local Government Employee Retirement Systems offer some type of service purchase option, and of the plans that do not offer service purchase, nearly half are dedicated to firefighters, police officers, or judges, whose members are predominantly career employees or who are less likely than other employee groups to terminate prior to retirement.

**Other examples of DB plan flexibility and portability**

During the past decade many large public DB plans have incorporated a variety of features increasing flexibility and portability, while retaining DB plan features. For example:

- Most new public employees in Washington state now participate in a hybrid plan, in which the employer funds a DB benefit more modest than that provided to longer-tenured employees, and the employee contributes to a DC plan.
- The Arizona State Retirement System offers participants with five or more years of service a portion, up to 100%, of the matching contributions made by their employer. Terminating employees with five years of service are entitled to 25% of the employer contributions made on their behalf, rising to 100% for terminating employees with ten or more years of service. Participants terminating with less than five years of service receive their contributions plus accrued interest.
- The Colorado Public Employee Retirement Association matches fifty percent of employee contributions withdrawn by non-vested employees who terminate.
- Many states provide an employer match to employee contributions made to a supplemental DC plan, such as a 457 or 403(b).
- Participants in the Public Employee Retirement System of Idaho share a portion of the system’s investment gains, which are deposited into individual DC accounts. Participants may make also
elect to make contributions to these DC accounts.

- The Wisconsin Retirement System and Ohio PERS provide a hybrid retirement benefit, basing participants’ pension on a combination of DB and DC plans.

These are just a few of many examples of public DB plans offering flexibility and portability while retaining the central feature of a DB plan: a guaranteed source of retirement income that reflects the worker’s salary and length of service.

**Portability caveat**
An important concern about retirement plan portability is that many terminating employees do not transfer their retirement plan assets to another plan, such as an Individual Retirement Account or a future employer’s plan. Studies indicate that a majority of terminating DC participants spend their retirement savings rather than rolling them into other retirement accounts.

A good example of terminating participants spending, rather than saving, their retirement assets is in Nebraska, where state and county government employees historically have participated in a DC plan. A recent study of the Nebraska Public Employees Retirement System, conducted by a national actuarial consultant, found that 68% of terminating participants cashed out their assets rather than rolling them over to another retirement plan. This finding is consistent with a Hewitt Associates study which found that more than two-thirds of participants terminating from DC plans cash out their lump sum distributions rather than rolling them to other retirement accounts.

Such “leakage” of retirement assets from individuals’ retirement accounts increases future costs of providing retirement. This is because the assets that are spent, rather than saved and invested, must be restored eventually, either by the employee or the employer, or both.

In testimony before Congress, the president of the Employee Benefits Research Institute, said: “Preservation (of retirement assets) in the presence of portability is, in my mind, the largest single issue in the system today in terms of determining how much money will actually be available to provide retirement income in the 21st century. … Policymakers cannot fairly assess the portability issue unless they fully consider the consequences of money leaving the system versus money staying within the system.”

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The Myth: “DC Plans are better because they allow employees to manage retirement assets themselves”

Summary
Some employees do wish to manage their own retirement assets, and most DC plans not only allow, but require participants to manage their retirement assets. DC plans also shift the risk of managing retirement assets from the plan sponsor to individual participants. Unfortunately, most employees are at best mediocre investors, unlikely to generate an investment return that will ensure an adequate level of retirement income.

DB assets have a longer time horizon, enabling them to withstand market volatility better than individuals. DC investors have a shorter investment horizon, requiring them to hold a more conservative portfolio, which leads to lower returns and less retirement income.

NASRA believes that a DB plan should constitute an employee’s basic retirement benefit, and should be supplemented by a voluntary DC plan. This arrangement satisfies the objective of providing a guaranteed pension benefit, while giving employees, especially those wishing to manage their own assets, the opportunity to save and invest in accounts they manage and direct.

Analysis
A key difference between DC and DB plans is that DC plans provide the opportunity to create retirement wealth, while DB plans provide income security. The purpose of a retirement plan is not to empower employees, or to create sophisticated investors, or to make participants wealthy. The chief purpose of a retirement plan should be to promote financial security in retirement.

Requiring individual employees to bear the entire risk of assuring an adequate level of retirement income ignores the fact that most employees lack the knowledge of investment concepts and practices needed to succeed. When employees fail to save enough for retirement, they and their dependents may face indigence in their elder years and may be required to work in retirement. Some will become dependent on the state for public assistance.

The eighth annual John Hancock Financial Services Retirement Survey4 of DC plan participants, published in May 2002, stated “many have a cockeyed view of how investments work across the board.” John Hancock researchers said most DC plan participants will fall well shy of the estimated 75% of pre-retirement income needed to maintain the same lifestyle in retirement. The survey also documented numerous examples of ignorance of basic investment principles among DC plan participants.

The Nebraska Public Employee Retirement System had a similar experience. Despite considerable, sustained efforts to educate participants, public employees in Nebraska were directing 90% of all contributions to just three of the eleven available fund choices, and more than 50% of the DC plan assets were invested in the stable value fund.

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A 2003 Pension Research Council Working Paper found that “a significant group of workers lacks the psychological attitudes or interests needed to maximize retirement security.”

The Investment Company Institute reported in 2004 that one-half of all 403b plan assets (owned primarily by public employees) were held as annuity reserves in life insurance companies. Another 30 percent was held as variable annuities with mutual fund companies.

DB assets are invested on the basis of a long time horizon, enabling them to be invested more aggressively than DC assets, resulting in higher long-term returns. By contrast, DC participants, who are not professional investors and as a group tend to be risk-averse, must assume increasingly conservative allocations as they near retirement, resulting in lower returns during both their working years and in retirement. The long investment horizon and professional investment of DB assets generate higher returns that compound, creating substantially greater returns over the long-term.

Ninety percent of public employees participate in a DB plan, and a supplemental, voluntary DC plan is available to nearly all public employees. NASRA believes this arrangement accommodates those employees who wish to manage their own assets, while still assuring a pension benefit for all participants.

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The Myth: “An employee must spend his entire career with the same employer to benefit from a defined benefit plan.”

Summary
DB plans reward workers who remain with their employer long enough to become vested members. DB plans are intended to reward long-term employees: encouraging longevity among quality employees is a primary retirement plan objective—one that DB plans help promote, and that DC plans do not.

However, an employee does not need to spend his or her entire career with the same employer to benefit from a DB plan. A DB plan provides a guaranteed retirement payment for vested participants; in most public retirement plans, vesting takes five years or less. Many public retirement plans allow participants to transfer or purchase service credit from other plans. Most public plans pay interest on participant contributions, and some entitle terminating participants to their employer contributions.

Depending on the age of the participant when beginning and terminating employment, a DB plan can provide a retirement benefit that is greater than the benefit from even a well-invested DC plan, even for employees who work only for a short period of time.

Analysis
By rewarding longevity, DB plans assist employers in retaining quality employees and encouraging longevity. This feature is especially helpful in the public sector, where salaries often lag behind the private sector, requiring employers to compensate in other ways. One of the chief arguments in favor of DC plans—their portability—can work against employers seeking to retain quality employees.

Yet it is misguided to believe that a DB plan benefits only those who spend many years or an entire career with the same employer. A chief strength of DB plans is that they offer participants a guaranteed retirement benefit funded with assets that are professionally invested.

By contrast, the benefit created by a DC plan is uncertain, determined largely by the participant’s investment decisions and ability to resist cashing out retirement assets prematurely. These are uncertain factors on which to base a worker’s retirement income security. When a DC plan is an employee’s primary retirement benefit, such uncertainty may fail to fulfill the purpose of a retirement plan for both the employee and the employer.

Even for long-term employees, a DC plan provides no assurance of a retirement benefit that exceeds or
even meets the benefit provided by a DB plan. This is because DC plans place the investment risk on the employee, and employees whose investment returns are sub-par over the course of a working life are likely to experience a lower retirement benefit than under a DB plan. The chapter *Employees want to manage their own retirement assets* addresses the likelihood of the typical DC participant achieving an investment return high enough to generate sufficient retirement savings.

Differences in benefit levels provided by DB and DC plans vary, and are determined by many factors, including the age of the employee when entering service. For example, assuming typical contribution rates and rates of investment return, an employee beginning a job at age 50 is better off in a typical DB plan regardless of how long he or she works. An employee entering service at age 45 will be better off in the DB plan after five years of service. This trend continues down the age scale—the younger the employee, the more time a DB plan needs to be relatively advantageous. This analysis is based on the attainment of investment return assumptions and the use of lump-sum distributions, two factors that endanger long-term retirement income security.

The chapter on portability addresses the growing use of service purchase provisions, which allow employees who move from one state to another to transfer their DB service credit with them. Similar provisions permit employees who terminated and cashed out their DB assets in previous years, to purchase those back when they re-enter employment. These and other public plan provisions accommodate employees who relocate or who move in and out of public employment.

Today’s workforce is older than it was twenty years ago, and older workers are more aware of their retirement income needs. This awareness promotes an understanding of and appreciation for DB plans. A DB plan helps employers, including government, to recruit and retain quality employees in today’s competitive labor market.

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6ORP Alternatives, Gary Findlay, presented to The Southern Conference on Teacher Retirement, 5/24/00
The Myth: “Public employees in defined benefit plans need to worry about politicians mishandling their funds, creating unfunded liabilities, and cutting benefits.”

Summary
Defined benefit public pension funds are trusts, typically administered by a governing board whose members are fiduciaries, or by a sole trustee who serves as a fiduciary. Every state has established prudence standards to govern the investment and management of assets, and most public pension plan administrative officials typically prepare financial statements in accordance with generally accepted accounting principles that are subjected to independent audits in accordance with generally accepted auditing standards.

Federal constitutional provisions governing contracts and property rights are generally perceived to protect pension benefits from diminution. In addition, some state constitutions explicitly prohibit reductions in pension benefits; most other states employ statutes or case law to prohibit or limit efforts to reduce public employee pension benefits.

A legislature wishing to reduce retirement benefits can do so more easily under a DC plan than with a DB plan. DB plans have liabilities for which plan sponsors are responsible; DC plans do not.

Further, the idea that public employees must worry about elected officials creating and then ignoring unfunded liabilities is not realistic. Typically, political jurisdictions are legally obligated to pay off any unfunded the liabilities of the DB plans within their purview. Any jurisdiction not responsibly financing its DB plan ends up with a net-pension obligation that must be disclosed in the plan sponsor’s financial statements. Accordingly, plan sponsors are motivated to ensure that plans are properly financed, because disclosure of a net pension obligation can negatively impact a jurisdiction’s credit rating.

Analysis
Mishandling Public Funds
First, once contributed to the pension trust, they are no longer “public funds.” The ability of elected officials to “handle” public pension funds is very limited. Most members of pension plan governing boards are appointed, not elected officials, and many are also members of the plan. All pension plan trustees are fiduciaries, including those who are elected officials, and are subject to fiduciary standards. An overarching theme of fiduciary standards is that the fiduciary must carry out his or her duties in the sole interest of plan participants, consistent with applicable laws, regulations, and policies.
In every state, fiduciary standards that govern the investment of assets include either a prudent person rule, a prudent investor expert rule, or a blend, or a variation of one or both.

The prudent person rule states that the fiduciary “is under a duty to the beneficiary to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived...”

The prudent expert rule, prescribed in ERISA as the standard for private sector pensions, requires that the pension plan fiduciary discharge the duties of that position “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

None of the standards permit elected officials to “mishandle” public trust funds.

Creating Unfunded Liabilities
Simply expressed, states are responsible for covering the liabilities of the pension plans they sponsor. An unfunded liability is the result of the actuarial cost of benefits (liabilities) exceeding the actuarial value of assets. Elected officials can create an unfunded liability by authorizing benefits without providing immediate assets sufficient to pay for them; by not making adequate contributions to the retirement plan; or by managing or directing investments that result in returns lower than the actuarially assumed return rate. If a legislature creates pension liabilities, the state is still legally required to meet its pension obligations.

Contradicting the assertion that public employees need to worry about elected officials creating unfunded liabilities, the overwhelming majority of state and local pension plan sponsors traditionally have made all required contributions to their pension plans. One result of this has been that public pension plans as a group have amortized their pension liabilities in a manner similar to how a homeowner pays off a mortgage. Public plans covering a large percentage of public employees are now fully funded, and plans covering most other employees are nearly fully funded.

Cutting Benefits
Most states protect public employees pension benefits through their constitution, statutes, or case law. Public pensions also enjoy protections provided through property rights law: “Under federal and state constitutional law notions of due process, property or a property right cannot be adversely impacted or taken by a governmental entity without observing procedural considerations. Pension benefit coverage and entitlement will

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Calhoun and Moore, “Governmental Plans Answer Book,” Panel Publishers
generally be considered to be property bringing due process protections.”

A DB plan actually is an effective vehicle for reducing the possibility of arbitrary benefit reductions, because inherent in a DB plan are liabilities for which the plan sponsor is responsible. If a legislature wished to reduce future benefits for current or future employees, it would be easier to do so with a DC plan, as there are no employer liabilities associated with that type of plan. If “politicians cutting benefits” is a concern, a DB plan is a more effective means of preventing such actions.

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8 Lawrence A. Martin, “Legal Obligations of Public Pension Plan Governing Boards and Administrators,” published by the Government Finance Officers Association
The Myth: “DC Plans Cost Less than DB Plans”

Summary

Retirement plan expenses fall into one of two categories: administrative expenses, which include recordkeeping and investment management; and the cost of the benefit itself, reflected in the form of employer contributions. In almost every instance, the administrative cost of a DC plan is higher—often much higher—than that of a DB plan. The difference between these plan types is in who pays the administrative cost: the employer usually incurs most of the cost of a DB plan; the participating employee normally pays all or most of the administrative cost of a DC plan.

If an employer seeks to reduce the costs of its retirement plan by lowering contributions, the result will be a lower level of assets available for benefits. In addition, by diverting participants from an existing DB plan to a DC plan, DB plan costs in many cases will rise, and the employer will likely be required to continue to maintain its DB plan, mitigating or nullifying any expected budget savings.

Analysis

Administrative Costs

Although the administrative cost of each retirement plan varies, in almost every instance, DC plans cost more—usually much more—than DB plans. Two factors account for most of the difference in DC and DB plan expenses. First, unlike DB plans, DC plans maintain individual accounts that are typically updated daily with information that is made accessible to the participant. Secondly, the size of DB plans covering most public employees creates an economy of scale, lowering the cost of administration and investment management.

Most DC plans use mutual funds or similar instruments as investment options. The average expense ratio for a stock mutual fund is around 1.5% of assets; the typical bond fund expense ratio is approximately 1.1% of assets. When costs for recordkeeping, participant education, and other administrative expenses are added, the annual cost of a DC plan can rise to as much as 2% of assets. This rate does not include the start-up costs needed to create a new DC plan; start-up costs generally are borne by the employer, either through expenses from the general operating fund or by drawing on assets from an existing retirement plan.

By contrast, a review of 12 of the nation’s largest public DB plans, which provide pension coverage for more than one-third of all active state and local government employees, found an average annual expense ratio of 0.25%, including costs for administration and investment management. Corroborating this finding is a California state law that
places a limit of 0.18% on the administrative expenses of county pension plans. When expenses are included for investment management and other activities outside the allowed limit, the total cost of these California county plans is well under one percent. Although smaller public pension plans are likely to have higher relative costs than larger ones, we can safely conclude that a substantial majority of public DB plans have an expense ratio that is considerably less than that of a typical DC plan.

Public DB plans are able to reduce their costs through economies of scale attained by their size, by negotiating favorable investment management fees, and in some cases by investing some assets using internal staff rather than external managers. Also, DB plans do not provide some services that drive DC plan costs higher, such as updating participant accounts on a daily basis and distributing quarterly statements.

Lower expenses have the same end result as higher investment returns. Higher returns increase the pool of assets available for pension benefits, and reduce required contribution rates. Higher investment costs have the opposite effect. Lower returns reduce the assets available for retirement benefits. For example, a DC plan with an expense ratio of 1.5% will reduce a participant’s 8% investment return to 6.5%. Compounded over time, this difference will have a substantial negative effect on the value of a retirement account.

In his essay, *In Defense of the Defined Benefit Plan*, Gary Findlay presents the basic retirement benefit equation:

Reduced to its simplest form, the financial mechanism behind the operation of both types of plans may be described by the formula:

\[ C + I = B + E \]

Where:

- \( C \) = Contributions (employer, employee, or both)
- \( I \) = Income from investments
- \( B \) = Benefits paid
- \( E \) = Expenses for plan administration

Findlay then explains the effects of expenses on each plan type:

In a conventional DB plan, the amount of ‘\( E \)’ will usually be a small fraction of a percent of the assets under management. The amount of ‘\( E \)’ will increase the amount of the employer’s ‘\( C \)’, but will not have an impact on ‘\( B \)’.

In a DC plan, with investment vehicles being individually selected by employees, it is not unusual for ‘\( E \)’ to be in the range of 1% to 2% of assets under management. The amount of ‘\( E \)’ will not affect the employer’s ‘\( C \)’, but will have an impact on ‘\( B \)’. (The greater the expenses, the less there is available for benefits.)

Findlay’s formula is illustrated by the following example:
An employee begins working at age 25, and leaves his employer at age 35 with a retirement account balance of $50,000. If this balance earns 8% (8.5% minus 0.5% for expenses) the account value will be $437,000 when the employee reaches age 65. The same starting balance earning 7% (8.5% minus 1.5% for expenses) will have a value at age 65 of $330,000, a difference of $107,000, or 25% less.

A DB plan typically does not pay benefits on the basis of individual participants' account balance. However, the effect of higher fees is fundamental: they reduce the amount available for pensions and other benefits; or they increase required contributions.

Costs and consequences of switching from a DB to a DC plan
Attempts to reduce costs by replacing a DB plan with a DC plan are unlikely to produce the anticipated level of budget savings. As described by Cynthia Moore in *The Preservation of Defined Benefit Plans*, laws governing public pension plans generally protect pension benefits from diminution. This prohibition against reducing benefits requires a public employer to continue administering its DB plan at least for existing plan participants. If a DC plan also is established, the employer will need to administer both plans, limiting any budget savings.

Also, some methods used to value public pension plan liabilities rely on continuous flow of new, younger members to help fund the cost of the plan’s liabilities. For plans that use such valuation methods, diverting future employees from a DB to a DC plan can increase the cost of the DB plan.

One predictable consequence of a DC plan whose benefits prove inadequate is political pressure to create or revert to a DB plan. This situation recently occurred in Nebraska, where the DC plan failed to create a sufficient level of retirement income security for plan participants. Nebraska switched to a cash balance plan. Switching from a DC to a DB plan can result in shifting pension plan costs to future taxpayers, as insufficient pension accruals under the DC plan are funded.

DC plans offer certain advantages, including greater portability, the opportunity for participants to manage their own investments, greater access to account information, and a chance to directly benefit from investment returns that exceed market averages. But these advantages come with risks: investment risk that is borne entirely by the participant; the risk of leakage, when assets are cashed out and spent before retirement; longevity risk, when participants outlive their retirement assets; and the risk of diminished retirement savings as a result of high administrative expenses.
The Myth: “Workers want a defined contribution plan as their primary retirement benefit.”

Summary
The reality is that most workers are unfamiliar with the differences between defined contribution and defined benefit plans. To the extent that employees have preferences for a retirement benefit, they are more likely to be for the features of the benefit rather than for a particular plan type; workers understand features like value, portability and flexibility, investment risk, and retirement income security.

A DB plan offers considerably more opportunity than does a DC to design a retirement benefit with features that are attractive to employees. In doing so, the DB plan facilitates a key objective for offering a retirement benefit: assisting employers in attracting and retaining quality workers.

As evidence of employee preferences for their retirement benefit, in recent years, when given the opportunity to choose between a DB and a DC plan, preponderant majorities of public employees have chosen the DB plan.

Analysis
Over the past two decades, many Americans have become familiar with the term 401(k) plan. In the wake of more than three years of equity market declines and corporate accounting scandals, the 401(k) plan also is perceived as a risky and unreliable retirement benefit arrangement.

401(k) plans are only the most popular and recognized of several forms of defined contribution plans. Among public employees, 403(b) and 457 plans are common. Regardless of which plan type is available, recent equity market declines have heightened participant sensitivities about some plan features when a DC plan is an employee’s primary potential source of retirement income. These pitfalls include:

- retirement plan account balances can decline, and sometimes they decline significantly
- these plans offer no assured retirement benefit
- plan assets can be exhausted well before death
- requiring amateur investors to make their own investment decisions can result in poor returns, even in a rising market
- market conditions at the date of retirement can significantly affect the level of retirement income available

The abstract notion, which may have peaked during the late 1990’s, that a DC plan can generate considerable wealth, has given way to a more sober and realistic perception that a DC plan by itself is an unreliable and precarious method for attaining retirement income security. Although DC plans have many positive attributes, this plan type is limited in its ability to include features that meet important employer objectives and that are attractive to employees.

By contrast, a DB plan design lends itself to extensive creativity to accommodate employer needs, including attracting and retaining quality employees. Some features that are attractive to employees and that can be designed into a DB plan include value, portability and flexibility, reducing investment risk, and increasing retirement income security.

Value
As with any other form of compensation, value is a primary consideration when assessing a retirement benefit. A worker’s perception of value in a retirement benefit may take several forms, perhaps most notably the presence and size of an employer contribution, and some protection against loss of principal.

Nearly all DB plans offered to public employees provide an employer contribution; in some cases, public employers fund the entire cost of the DB plan. This increases the ability of employees to contribute to a supplemental DC plan account or other savings plan.

By definition, a DB plan protects participants’ principal. Vested DB plan participants qualify for a retirement benefit that is assured regardless of market performance. By contrast, DC plans typically provide no protection against market losses: even the most generous employer contribution to a DC account can be eroded through poor investment returns.

**Portability and Flexibility**

This paper’s chapter on portability highlights the progress DB plans have made toward providing portability to plan participants, including reduced vesting periods, distributing employer contributions to terminating participants, and paying interest on participant accounts.

DB plans also offer flexibility. For example, a growing number of DB plans feature PLOP’s—partial lump sum option plans. A PLOP allows retiring participants to take a portion of their retirement annuity as a lump sum. DROP’s – deferred retirement option plans—also make DB plans more flexible and portable by allowing employees to postpone retirement and accumulate a cash balance that supplements their retirement annuity.

Most DC plans offer more portability than DB plans. Yet as discussed in the chapter on portability, too much portability can damage long-term retirement income security. Evidence shows that a majority of terminating participants cash out their DC plan assets, rather than rolling them into another retirement account. This defeats a fundamental retirement benefit objective—providing a source of retirement income.

Similarly, portability challenges retiring DC plan participants, as retirees have no assurance their assets will last the remainder of their lives. Retirees may spend all their assets at once, or at a rate that exhausts the assets well before their death.

In theory, portability and flexibility are salutary features of a retirement benefit, and to some extent, these features add value. Prudent retirement plan design, however, which considers the long-term retirement income security of plan participants, suggests there should be some limit on the extent of the plan’s portability and flexibility.

A DB plan enables employers to balance the plan’s portability and flexibility while protecting participants’ long-term retirement income security needs. There are restrictions to offering such balance through a DC plan.

**Investment Risk**

The opportunity to manage their own retirement assets appeals to some employees. Most public employees have access to a voluntary DC plan that supplements their DB plan, enabling those who wish to manage a portion of their own retirement assets to do so.

As discussed in a previous chapter, most employees do not consider themselves to be knowledgeable about investments. Experience demonstrates that employees engage in a variety of practices resulting in investment returns that often fall well short of both market returns and returns of professional investment managers. This is a primary reason for NASRA’s support of a DB plan as an employee’s primary retirement benefit arrangement, supplemented by a voluntary DC option.
The Experience of Employee Choice
Since 1997, large numbers of public employees in Michigan, Florida, Ohio, and South Carolina have been given an opportunity to participate in a DC plan as their primary retirement benefit. The experience in these states creates a persuasive case study of employee retirement benefit preferences.

In each case except Michigan, the employer contribution equaled or exceeded the contribution to the DB plan; in Michigan, the employer contributes four percent of salary plus a matching amount of up to an additional three percent.

In each state, an overwhelming majority—more than 90%—of those eligible to switch elected to stay with the DB plan.

This experience is consistent with a survey conducted by the Ohio Public Employees Retirement System of its members with less than five years of service credit. The purpose of the survey was to determine these employees’ attitudes and preferences for a retirement benefit. The findings of Ohio survey included the following:

- When members were asked to rank the importance of 17 plan design features, the ability to direct money to a private investment company ranked 16 out of 17. Among the highest ranked features overall were portability, guaranteed monthly benefit after retirement, and health care coverage.
- A majority of members did not consider themselves to be knowledgeable about investments.
- More than half of the members surveyed (56%) expressed a preference for the DB plan, and an additional 32% said they would select the Combined Plan, which combines features of a DB and a DC plan. 6.4% said they would select the DC plan.
The Myth: “Workers in defined contribution plans will receive substantially higher benefits than those offered by defined benefit plans.”

Summary
Although accumulating wealth is an admirable objective, the chief purpose of an employer-sponsored retirement plan is not to make workers rich. Rather, the central purpose of an employer-sponsored retirement plan is to promote workers’ retirement security.

Among participants whose primary retirement benefit is a defined contribution plan, some will, in fact, receive substantially higher benefits than they would under a defined benefit plan. However, many workers will fare worse under a DC plan, and some DC plan participants will have no retirement assets at all.

By providing an assured benefit whose value is known in advance of retirement, a DB plan meets the fundamental and imperative objective of a retirement benefit: to promote retirement security.

Analysis
Proponents of establishing a DC plan as workers’ primary retirement benefit contend that simple math illustrates a compelling argument in their favor: by calculating the contributions an employee and his employer will make during the employee’s working life, and factoring in projected investment returns, a DC plan will generate a larger annual benefit than would be available through a DB plan.

The problem with this argument is that it ignores decisions made by plan participants that can reduce and even eliminate the value of a DC plan. Some of these decisions are discussed in greater detail previously in this paper, and are summarized briefly below.

Factors Limiting the Value of a DC Benefit
• Many DC plan participants “cash out” their retirement savings when changing jobs, instead of transferring those assets to another retirement savings plan. A recent study by Hewitt Associates found that 42% of 160,000 401(k) plan participants who terminated employment cashed out their assets, rather than rolling them to an IRA or to a future employer’s retirement plan. This paper’s chapter on portability presents substantial empirical evidence of pervasive “leakage” from retirement savings accounts.

• Most workers make poor investors, resulting in investment returns well below the level needed to ensure retirement security. The chapter on DC plan participants managing retirement assets themselves describes workers’ lack of knowledge and financial acumen necessary to generate investment returns anywhere near those assumed by DC plan advocates. The studies cited in this chapter describe a litany of harmful investment strategies engaged in by DC plan participants, such as taking on excessive or inadequate investment risk, market timing, borrowing from their retirement savings, and following trends, rather than establishing and staying with an appropriate asset allocation.
Contrary to the theoretical models presented by DC proponents, every worker does not promptly enter the workforce in a full-time job after completing high school or college, and continue working until reaching retirement age. A substantial body of research has described the growth in so-called non-standard work arrangements, in which many jobs are seasonal, part-time, temporary, contract, or otherwise not permanent and full-time. The 2002 Census of State and Local Government and Payroll found that state and local governments employed 13.8 million full-time employees and 4.5 million part-time workers. Whatever pension arrangements are in place for these part-time workers, their contributions are undoubtedly less than those implied in the models used by DC plan proponents.

Non-standard work arrangements are especially prevalent among workers under the age of 35, a time when making contributions and taking advantage of compound interest is critical to accumulating sufficient assets to ensure retirement security.

Similarly, many employees move into and out of the workforce for a variety of reasons, such as to have and raise children, for other family reasons, and for retraining or to increase their education. Some workers stop working before reaching normal retirement due to health reasons. In each of these instances, contrary to the assumptions of DC plan advocates, DC plan contributions are not being made.

Each of the factors listed above results in fewer assets available to plan participants at retirement. A worker who experiences one or more of these factors is likely either to have lower benefits in retirement than those offered by a DB plan, or to be required to work longer than they would if a DB plan were their primary retirement benefit. The idea that DC plan participants will retire with higher benefits is simply untrue for many workers.

Effects of Longevity and COLA’s

Even for a DC plan account with an initial retirement benefit that is greater than the benefit the worker would receive under a DB plan, there is good chance that the real purchasing power of the benefit will fall below that of a DB plan during the worker’s remaining life. There is also a chance that the worker will outlive his or her assets.

The median life expectancy of a 65 year-old American is 85. One-fourth of all women in America age 65 will reach 93; one-fourth of American men who are 65 will live to be 88. Most DC plans contain no cost-of-living provision. Yet, an annual inflation rate of 2.5 percent from age 65 to 93 will reduce the purchasing power of a retirement benefit by more than half.

Even worse than a benefit that is deteriorating due to inflation is a benefit that is exhausted before death. Yet this is a very real possibility for retirees with a DC benefit who live long enough, or who spend their assets quickly enough.

Thus, even in cases where a DC benefit initially exceeds the amount that would be provided by a DB benefit, that advantage is likely to disappear during a worker’s retired life. For these reasons and others described throughout this paper, NASRA supports a defined benefit plan as a worker’s primary retirement benefit, supplemented by a voluntary defined contribution benefit.