DB Pensions: The Real Deal

By Beth Almeida

The recession has put intense pressure on the budgets of state and local governments, prompting officials to take a harder look at spending on all manner of public services. Naturally, this scrutiny also extends to retirement benefits for state and local workforces. As states and localities across the country re-examine their retirement benefit offerings, they strive to ensure that these programs remain affordable for taxpayers, provide adequate benefits for employees, and still allow public employers to remain competitive in the market for talent.

As we look across the nation, we see governments making a number of changes to their retirement plans—increasing contributions, adjusting retirement ages, and modifying benefit design. However, governments' commitment to defined benefit (DB) pensions has generally not wavered. That has been a surprise to some who have called for the public sector to follow the path of the private sector, away from DB pensions and toward greater reliance on defined contribution (DC) plans. But the resilience of DB pensions in the public sector is less surprising to those who understand that these plans are ideally suited to serve the interests of all of the key stakeholders involved—taxpayers, employees, and public employers. Here are three reasons why DBs have proven to be such a durable feature of the compensation landscape in state and local government.

1. DB pensions work for taxpayers—they squeeze more value out of each dollar contributed. Citizens want to know that their tax dollars are being used in the most efficient manner possible, and that includes taxpayer support of retirement benefits for public employees. At the same time, it's important to remember that the financing of pensions in the state and local sector is typically a shared responsibility; contributions come from both employees *and* taxpayers. This shared financing model may be a reason why DBs have been so durable in the public sector, even as they have dwindled in the private sector, where they are employer-financed. Moreover, DB pensions make good use of contribution dollars—whether from employees or taxpayers—because these plans are able to more efficiently pool risks and costs than other alternatives, such as 401(k) plans.

As I have previously written with co-author William Fornia in this Journal, the key characteristics that make DB plans attractive to employees—low costs, professional asset management, and access to a lifetime income—are also the source of impressive economic efficiencies which benefit taxpayers [Beth Almeida and William Fornia, "Defined Benefit Plans: A Better Bang for the Buck," *Journal of Pension Benefits*, Vol. 16, No 2, Winter 2009, pp. 11–15]. In our previous article, we presented an apples-to-apples comparison of what it would cost to provide a lifetime income of about $2,200 per month to a group of employees, first under a typical DB plan, and then, under a typical defined contribution plan. We calculated that a typical DB plan could do the job at 46% *lower cost* than a typical DC plan. Now that's a fiscally responsible approach to providing benefits.

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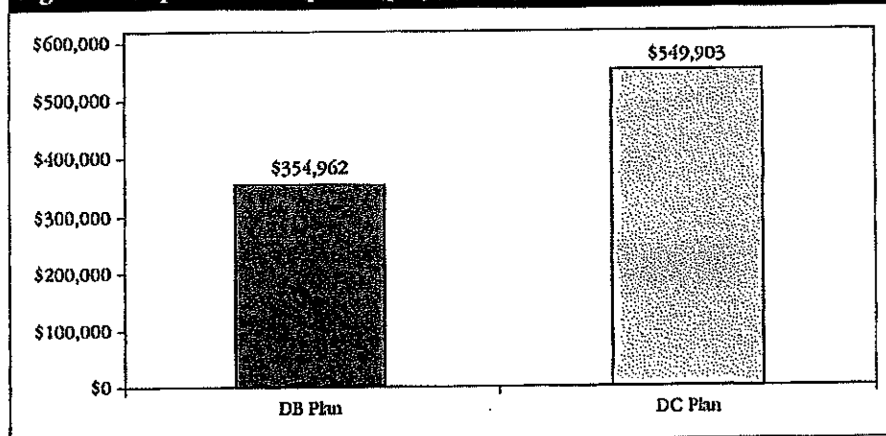
There are three reasons for DB's cost advantage. First, as many researchers have documented, DB plans outperform DC plans when it comes to investment returns. Better investment returns over time mean that less money needs to be contributed on the front end to finance any given level of benefits. Second, unlike individuals, whose lifespan is finite, DB plans need not down-shift to an ever more conservative portfolio over time. As a result, DB plans can maintain better investment returns over time, as compared with individuals in DC plans. And again, better returns equal lower costs. Third, DB plans pool longevity risks in a large group, whereas in a typical DC plan, individuals must self-insure the risk of outliving their savings. Another way to say this is that DB pensions can plan for the *average* life expectancy of a group, where as an individual must plan for the *maximum* life expectancy, if she wants to avoid running out of money. The pooled approach taken by DB plans allows fewer dollars to be set aside for each individual, reducing costs.

These built-in economic efficiencies enable DB plans to stretch each dollar of contributions further, making DB plans a better deal for taxpayers and employees alike. This is the key reason why DB pensions remain the dominant way to provide retirement benefits in the public sector.

2. DB pensions work for employees—they provide life-long retirement security. The primary purpose of a retirement plan is to provide benefits that will enable an employee to cease working at some point and have a source of income to sustain his or herself for the remainder of one's life. DB pensions are uniquely designed to serve as retirement income vehicles, in contrast to DC plans, which are savings (or wealth accumulation) vehicles. While both types of plans are important for a secure retirement, it is well established that DC plans come up short when called upon to serve as the primary retirement vehicle. [For a comprehensive review of the literature, see Teresa Ghilarducci. *When I'm 64: The Plot Against Pensions and the Plan to Save Them*, 2008, Princeton, NJ: Princeton University Press and Alicia Munnell & Annika Sunden, *Coming Up Short: The Challenge of 401(k) Plans*, 2004, Washington, DC: Brookings Institution Press.] Researchers have also established that having income from a DB pension truly makes the difference between a secure retirement and struggling financially in old age, especially for middle class Americans.

For example, for several years now, researchers at Boston College have assessed the risk Americans face of being unable to maintain their middle-class standard of living into retirement. Their findings are striking: Fully half of Americans will be unable to maintain their standard of living, or something close to it, in their older years. This represents a stunning reversal from recent decades, when large majorities of Americans could look forward to a secure retirement [Alicia Munnell, Anthony Webb & Francesca Golub-Sass, "The National Retirement Risk Index: After the Crash," Issue Brief 9-22, October 2009, Chestnut Hill, MA: Boston College Center for Retirement Research]. A key driver of this trend is the decline in DB pension coverage in the private sector. Indeed, the researchers found that having at least some income from a DB pension cuts retirement risks by half, as compared with those who lack such income. By

Figure 1: Required Assets per Employee at Age 62 to Fund Target Benefit



contrast, those covered by a DC plan still face a 50-50 chance of falling short in retirement. For a member of the early Baby Boomer generation (born from 1946–1954), those are the same odds faced by someone who has no retirement plan on the job at all [Alicia Munnell, Anthony Webb & Luke Delorme. "A New National Retirement Risk Index," Issue Brief 06-48, June 2006, Chestnut Hill MA: Boston College Center for Retirement Research].

In the public sector, the adequacy of retirement income is a special consideration, because the state, as the provider of last resort, will ultimately be responsible for those who can no longer work and require assistance to meet basic needs. Thus, government (i.e., taxpayers) can either "pay now" by ensuring workers have the opportunity to accumulate adequate resources for retirement or "pay later" in the form of providing public assistance.

It turns out that DB pensions are highly effective at keeping older folks out of poverty and away from dependence on public assistance. A recent study released by our institute reported that poverty rates among older households lacking pension income are about six times greater than those with such income [Frank Porell and Beth Almeida, *The Pension Factor: Assessing the Role of DB Plans in Reducing Elder Hardships*, July 2009, Washington DC: National Institute on Retirement Security]. The same study found that poverty rates among the elderly today would be some 43% higher were it not for DB pensions. As a result, expenditures on public assistance would grow by a similar proportion (40%). The analysis was repeated for DC plans, and while income from DC plans had some impact in protecting seniors from financial hardship, it was decidedly modest, compared to the large poverty-reducing effects of DBs.

Clearly, DB pensions have a proven track record of delivering on the key objective for middle class Americans—having sufficient income to maintain a middle-class standard of living into old age.

3. DB pensions work for employers seeking to recruit and retain talent to public service. More than 14 million Americans serve the public working for state or local government. They work in occupations as diverse as teaching, public safety, criminal and civil justice, public health, and many others. As a group, employees of state and local government are highly skilled—about half hold a college or advanced degree. That is double the proportion of the private sector workforce that is college educated.

Given the current condition of the labor market, recruitment and retention may seem like secondary issues. However, a recent survey of government hiring managers indicates that even in this weak labor market, state and local employers struggle to fill vacancies for highly-skilled positions, such as engineering, environmental sciences, information technology, and health care professionals ["The Great Recession and the State and Local Government Workforce," January 2010, Washington DC: Center for State and Local Government Excellence].

These hiring difficulties likely stem from a persistent pay gap between the public and private sectors. A new study finds that employees of state and local government earn salaries that are respectively 11% and 12% below those of their private sector counterparts. The study finds that good quality benefits offered to public employees help to narrow the compensation gap, but they do not close it entirely. Even after accounting for the value of benefits, employees of state and local government still earn about 7% less than their counterparts in the private sector [Keith A. Bender & John S. Haywood, *Out of Balance? Comparing Public and Private Sector Compensation Over Twenty Years*, April 2010, Washington DC: Center for State and Local Government Excellence and National Institute on Retirement Security].

So how do public employers remain competitive in the market for talent? Offering DB pensions is one way.

Compensation specialists know that retirement plans (or other forms of deferred compensation) can have the effect of encouraging employee commitment to the employer by creating rewards for longer service. Indeed the dominant retirement plan design in public sector DB plans—the traditional final average pay plan—is one where long-tenured workers earn benefits more rapidly the longer they stay on the job. Economists long ago established that this type of plan has strong effects on retention. [For a review, see Gustman, A.L.O. Mitchell and T.L. Steinmeier, "The Role of Pensions in the Labor Market: A Survey of the Literature," *Industrial and Labor Relations Review*, Vol. 47, No. 5, 1994, pp. 417–438.] This continues to be the case, according to more recent research. A 2006 study finds that employees with a DB pension stay on the job four years longer than those with no retirement system in place and 1.3 years longer than those who have only a DC plan. Having a DB and a supplemental DC plan showed the greatest retention effects, as the two plans together increase tenure by a full

3.1 years, as compared with a DC only plan [Alicia H. Munnell, Kelly Haverstick & G. Sanzenbacher, 2006. "Job Tenure and Pension Coverage," CRR Working Paper 2006-18, Chestnut Hill, MA: Boston College Center for Retirement Research]. Another recent study compares the retention effects of DB and DC plans and finds that both seem to have a positive effect on retention, but the effect is significantly larger for DB plans [Steven Nyce, "Behavioral effects of employer-sponsored retirement plans," *Journal of Pension Economics and Finance*, Vol. 6, No. 3, 2007, pp. 251–285]. This study also finds that DB pensions significantly increase employees' commitment to their organizations, while coverage under a DC plan has no effect on employee commitment. Interestingly, these results are strongest among younger workers, who are often assumed to find DC plans more attractive.

These findings indicate that state and local government employers have good reasons to remain committed to the DB pension model. Current fiscal realities will in most cases preclude closing the public-private pay gap. However, maintaining DB pensions will aid public employers' recruitment and retention efforts, with the additional benefit of enhancing employee loyalty.

The Bottom Line

The public debate on retirement issues often assumes a zero-sum game. In other words, if DB pensions are good for employees, they must be bad for employers and/or taxpayers. But, as this review demonstrates, DB pensions, if properly structured and managed, can serve the interests of all stakeholders—taxpayers, employers, *and* employees.

The caveat "properly structured and managed" is an important one. It is obvious that plans can come under severe strain when funding policies are disconnected from benefit policies. Even worse are situations where benefits and funding are not guided by well-considered policies, but rather subject to *ad hoc* decisions that may be driven more by short-term political considerations than a long-term balancing of interests among employers, employees, and taxpayers. Worst of all are the rare but troubling instances of improper conduct by officials entrusted to oversee these plans. These are the situations that grab headlines and can undermine public confidence in all public pensions, even those that are models of success. Consequently, these are also the situations where prompt reform is in order, but policymakers need to avoid throwing out the baby with the bathwater.

For plan sponsors who are serious about promising reasonable benefits and maintaining proper funding discipline, DB pensions remain a compelling proposition. DB plans squeeze value out of every taxpayer dollar they take in and they deliver honest-to-goodness retirement security to employees.

As we look ahead to a stronger economy in the future, pensions will help our states and cities build and maintain the public workforce that educates our kids, keeps our streets safe, and our air and water clean. Now that's what I call the real deal. ■