Defined Contribution vs. Defined Benefit Retirement Plans

IEA Position – OPPOSED TO DEFINED CONTRIBUTION

A **defined contribution (DC)** plan is like a 401k. In a defined contribution plan, the amount of money contributed by the employer and employee is specified while the retirement benefit earned by the member is based on the investment performance of those contributions at retirement. In DC plans members are given mutual funds or tax-deferred annuities as options to invest their money. A 403b is also an example of a DC plan.

Defined benefit (DB) plans specify a certain benefit for the member at retirement based on several factors. Most DB plans are based on length of service and final average salary multiplied by a certain percentage. In the Teachers' Retirement System (TRS) and the State Universities Retirement System (SURS), the percentage is 2.2 percent for each year of creditable service.

Why Change?
Proponents of defined contribution plans list the following advantages: portability costs, no unfunded liability and improved investment return. The real reason, however, may be that DC plans limit the risk and the cost of the employer or the state. In DC plans, the employee assumes all the risks of investing; while in DB plans, the employer or the state with the help of investment professionals assumes all the investment risk. In Illinois our retirement benefits are also protected by the Illinois Constitution. Whereas, the benefits of a DC plan are solely reliant on the stock market and are not protected by the Illinois Constitution.

Reasons for Opposition

- **No Social Security Benefits -** Teachers and those employed at our Universities receive *NO Social Security benefit* in retirement for their years of employment in those areas. This means that under a defined contribution plan their sole retirement would be reliant upon a tremendously volatile stock market. This is a huge distinction between public school teachers and private sector employees.

- **DC Is More Expensive than DB -** Private sector employers that offer either a pension plan or a defined contribution plan (401k) pay 7.65 percent in Social Security and Medicare taxes, plus 4.5 percent[1] or more for either a 401k plan or a pension plan for employees. This brings the total cost to 12 percent of salary for most employers. *TRS benefits earned during the current school year cost the state 7.4 percent of salary.*
  1. "56th Annual Survey of Profit Sharing and 401k Plans," Published By: Profit Sharing/401k Council of America.

- **A Pension Switch Will Not Solve the Pension Funding Problem -** The current $100 billion unfunded pension debt will still have to be paid if there was a new defined contribution plan. That debt cannot be erased because the state constitution specifically prohibits any decrease in benefits for people currently in the retirement systems.

Case Study

- Nebraska shut down their DC plan after discovering the DB plan investment returns doubled that in the DC plan.

- In 2006, Alaska moved all new teachers and state employees from the traditional pension plan to a defined contribution plan in an effort to curb the pension system's $5.7 billion unfunded liability. At the time, Governor Murkowski said that the change would, "stop the so-called bleeding." By 2014, the unfunded liability *had doubled to $11.9 billion*. The switch was a mistake, said Rep. Mike Hawker (R-Anchorage), "I very much was concerned when we closed our retirement systems and went to a defined contribution that by closing those systems we were going to find ourselves in the position we are in today, which was ultimately having to step in with a significant financial bailout." During the 2014 session, the

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Alaska Legislature was forced to infuse the pension system with an additional $3 billion, and extend the amortization period from 15 to 30 years. The amortization extension could cost Alaska taxpayers an additional $2.5 billion.

- In 1991, West Virginia moved its teachers from a traditional pension plan to a defined contribution plan. By 2003, the Teachers' Retirement System (TRS) hit the rock bottom funding ration of 18 percent, the lowest level benefits to two retired teachers for every one active member still paying into the fund. West Virginia actuaries projected that the state could save $1.2 billion in the first 30 years by returning to a defined benefit plan. After approval from the legislature and the governor, more than 80 percent of eligible teachers voted to return to the traditional pension system. TRS is now funded at 58 percent - closing more than half the funding gap in nine years.

- Despite managing a healthy fund, Michigan closed its pension system and began enrolling all new state employees in a 401(k) – type plan in 1997. Since then, the system has suffered, with unfunded liabilities skyrocketing from $697 million in 1997 to $5.4 billion in fiscal year 2012. The funding status of the plan dropped from a healthy 92 percent to 60.3 percent.

Risk of DC Plans

- Defined contribution plans shift the risk from the employer/state to the employee. If the employee invests poorly, the employee suffers at retirement.

- 42 percent of employees who left their jobs in 2010 cashed out their 401k; 41 percent of employees age 40-49 cashed out.

- Mortality risk (outliving your savings) through either investment mistakes and/or market decline. Buying into an annuity is a very expensive way to avoid mortality risk.

- Administrative expenses – The median cost of a DC plan is $1.40 for every $100 invested. This is according to the National Association of State Retirement Administrators.

Benefits of a DB Plan:

- The National Institute on Retirement Security conducted a study entitled, "Still a Better Bang for the Buck." The study concluded that the cost to deliver the same level of retirement income to a group of employees is 48 percent lower in a defined benefit pension plan than it is in a defined contribution plan.

- Reward for long-term employees – Defined benefit plans are typically based on final average salary, thereby rewarding long-service employees. The average TRS annuitant has 29 years of service.

- Additional benefits in DB plans – Most defined benefit plans provide additional benefits not provided in most DC plans like the following: guaranteed post-retirement increases (COLA), service credit for sick leave, military and maternity leave, early retirement, survivor's benefits and disability benefits.

- TRS's administrative and investment expenses are extremely low. It only costs $0.30 per $100 in TRS assets to run the pension plan.

Balanced Approach

We believe that the correct approach is to have a retirement package that includes all of the following:

- Defined benefit retirement plan(s) – current state retirement plan and/or social security.

- Optional defined contribution plans – current tax-deferred annuity plans.

- Post-retirement Health Insurance.