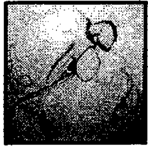

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# Why Defined-Benefit Plans Are Safer Investments for State Governments and Workers

Felix Salmon has a very smart post on the problems with moving public employees from traditional defined-benefit pensions to 401k's and other defined-contribution plans. As states feel the budget squeeze, many lawmakers are blaming public pensions for their fiscal woes. Utah, for instance, is facing a budget shortfall and is switching its retirement plan from a traditional pension to a 401k. Here's Salmon:

> So, the state of Utah has been putting insufficient money into its pension plan, and now there isn't enough money there to meet upcoming liabilities. And the solution here is for the state, in future, to contribute "roughly half" of what it's been spending up until now in pension contributions.
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> Needless to say, this makes no sense on either front. The liability to existing workers doesn't go away if a different plan is adopted for new workers, so the problems at the pension plan aren't being addressed. On top of that, it's hard to see how contributing much less to new workers' retirement is going to help them at all, either. From a pensions perspective, there's no winner at all: the only entity better off is the state, from a cashflow perspective.

Whether the state is better off is also in question. As Teresa Chilarducci notes, 401(k)'s are far more volatile than traditional pensions:

> “ 401(k) plans are bad deal for taxpayers. Dollar for dollar, a traditional pension plan yields more pension benefits than do 401(k) plans because 401(k) management and investment fees are three times higher. And professionals who manage money in pooled pension funds usually get higher returns than workers who manage their own 401(k) accounts. The only clear winners when pensions switch over to the 401(k) plans are brokers and bankers...
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> The unintended effect of widespread 401(k) plans is more volatility. In contrast to traditional pensions and Social Security, 401(k) plans fuel bubbles and make recessions worse. When the economy is booming, 401(k) plan asset values soar, making people spend more and work less. Not what you want in an expansion.
>
> Worse, when the economy plummets and takes 401(k) assets with it, people do the opposite; they cling to the labor market and rein in spending – again, two things you don't want in a recession.

Worse, defined-contribution plans open up a Pandora's box of potential problems down the road. Take the case of the West Virginia. In 1991 West Virginia lawmakers ended their defined-benefit plans for new teachers. All teachers hired after 1991 were placed on a 401(k)-style plan. Under a 401(k) employees pay into a personal retirement account and employers match their contributions up to a certain amount. This money is invested in stocks and bonds and is often left to the employee to manage. It's also tax-free up to a certain percentage of income, and portable. But it turns out, 401(k) plans are not for everyone:

> “ Fast forward to today. It turns out that for a very large segment of West Virginia teachers, the 401(k)-type plan hasn't panned out too well. According to a study done by West Virginia's Consolidated Public Retirement Board, the average account balance is just $33,944 and only a handful of teachers age 60 or older have amassed more than $100,000 in their accounts – a fraction of what the pension plan would've paid.
>
> What happened? Despite receiving an annual matching contribution equal to 7.5% of their pay, many teachers are claiming that they were improperly steered into low-yielding annuities, even though the plan offered more appropriate investment choices. Others say they received no guidance or education on such important topics as asset allocation and rebalancing.
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> So the West Virginia teachers now want a do-over. Essentially, they want to treat the past 17 years under the 401(k)-style system as though it never happened. They are asking to be put back – retroactively – into the traditional defined-benefit pension plan. Like a bad dream, their paltry 401(k) balances will disappear, to be replaced by the more generous pensions they would have racked up had they been in the traditional plan all along.
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> Of course, millions of private-sector workers would also like a second chance. According to an analysis of 20 million 401(k) participants conducted by the Employee Benefit Research

> Institute and the Investment Company Institute, the median account balance of a worker in his or her 60's, making between $40,000 and $60,000 a year (in the same ballpark as a retiring West Virginia teacher) was $97,588 at the end of 2006. To put that amount in perspective, it would generate only about $8,000 a year in retirement income if it were invested in an immediate annuity.
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> But back to West Virginia. Incredibly, the state legislature has already agreed to go along with this retroactive pension switchover – as long as 65 percent of teachers formally elect to make the voluntary changeover.

Did you catch that? The *average balance* on these plans was just $33,944 – not exactly a nest egg. Spread over just twenty years of retirement, that only gets you a little over $140/month. The *median account balance* at retirement of private-sector workers on a 401(k) plan is only $97,588, or just over $400/month. Compare this with a defined benefit of say $2,500/month for twenty years – the equivalent of a $30,000/year pension – and you get a total benefit of $600,000. This should give you a sense of how difficult 401(k) plans are to scale across the American workforce. As Salmon correctly notes:

> “ The fact is that the states' move to defined-contribution plans is a blatantly political one, born of Republican ideology conflating such plans with individual freedom and choice. For rich professionals who jump from job to job every few years, 401(k) plans do make a certain amount of sense. For public servants spending a lifetime in the police force or in elementary schools, by contrast, they emphatically don't. As for the state pension plans, the only way that the state governments can help them make up their actuarial liabilities is if they pour more money into them. Not less.

Well that's not the *only* way states can help their pension funds. They can also manage them more wisely and not put as much faith into Wall Street. The financial collapse and the housing bubble are the reasons these plans are in crisis to begin with after all.

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