

FACT SHEET

Myths and Realities: *Defined Benefit vs. Defined Contribution Systems Debate*

Myth #1:

“Switching the public sector from a defined benefit to defined contribution system would save states money.”

Reality:

- Defined contribution systems have significantly higher annual administrative costs than fully funded defined benefit systems.
- According to the Investment Management Institute, the operating expense ratio for defined benefit plans averages 31 basis points (31 cents per \$100 of assets); the average for defined contribution plans is three to six times higher at 96 to 175 basis points.¹
- To put that in context of the Illinois pension systems, the administrative costs of a defined contribution system would in all likelihood be anywhere from \$275 million to \$610 million more expensive annually than the state’s current defined benefit systems.

Myth #2:

“Defined benefit systems have inordinately high costs.”

Reality:

- The weighted average “normal cost” across all five Illinois pension systems, as a percentage of active members’ payroll, averages 9.13 percent.²
- The national average for state and local government is 12.5 percent,³ placing the normal cost of Illinois’ current defined benefit program far below the national average.
- Moreover, going forward, a fully funded defined benefit system can save taxpayers money annually that would be impossible to save under a defined contribution system.
- Under a defined contribution system, all investment returns belong solely to the employees’ individual account, good returns cannot be used to reduce annual costs to taxpayers. However, in a defined benefit system returns can and frequently do assist in reducing costs to taxpayers. Take for example the experience of the Illinois Municipal Retirement Fund (IMRF).
- The IMRF, the second largest pension fund in Illinois covering public employees such as bus drivers, sewer workers and municipal administrators, has enjoyed a funding advantage for years,

¹ Sean Collins, *The Expenses of Defined Benefit Pension Plans and Mutual Funds*, December 2003.

² Weighted average based on data provided by each of the five retirement systems.

³ Norman Jones and Paul Zorn, Harvard Law School, Pension and Capital Stewardship Project Conference, October 2005.

in large part because it has relentlessly demanded full and on time payments from member government employers and employees.⁴

- As a result, the IMRF has consistently maintained high levels of funding.⁵
- As of December 31, 2006, IMRF was 100.5 percent funded on an actuarial basis.⁶
- Because of this, government employers within the IMRF will enjoy lower contribution rates in 2007.⁷
- Rates will fall from an average 10.04 percent in 2006 to 9.72 percent this year, saving taxpayers millions.⁸

Myth # 3:

“Pension benefits offered to public employees in Illinois are overly generous.”

Reality:

- According to U.S. census data, the average monthly pension payment to state government employees nationally was \$1,374 in 2001-2002.⁹
- At the same time, the average Illinois payment was \$1,426, a difference of just 3.7 percent.¹⁰
- An annual retirement income of \$17,112 is barely enough to live on in Illinois. In fact, an annual income of \$17,112 is only \$3,422 away from the poverty level for a family of two under federal government standards.¹¹

Myth # 3:

“Illinois has too many public employees.”

Reality:

- The total number of participants in the state's various pension plans represents a meager 5.3% of Illinois' total population.¹²
- That's because historically, Illinois has not been a high public employee head count state.¹³
- Instead, Illinois is mostly a grant-making state—that is, rather than hire state employees to provide services, Illinois disburses grants to independent providers such as Lutheran Social Services or Catholic Charities, which in turn deliver the service to the public.
- Illinois actually ranks 50th among the states, dead last in the nation, in number of state employees per capita.¹⁴

Myth # 4:

“The significant shift from defined benefit to defined contribution systems in the private sector demonstrates the undue cost and uncompetitiveness of defined benefit systems.”

4 Murphy, Lee. “One State Pension Plan Back to Being Fully Funded” Crains. Feb. 21, 2007.

5 Ibid.

6 Murphy, Lee. “One State Pension Plan Back to Being Fully Funded” Crains. Feb. 21, 2007.

7 Ibid.

8 Ibid.

9 United States Census Bureau, Employee Retirement System of State and Local Governments. 2001-2002. (This is the latest available national data.)

10 Ibid.

11 2007 HHS Poverty Index for family of 2 is \$13,690. Taken from: United States Department of Health and Human Services, Federal Poverty Guidelines, 2007.

12 State of Illinois FY 2008 Budget Book.

13 United States Census Bureau, Statistical Abstract of the United States, 1993-2006.

14 Based on 2006 U.S. Census Data.

Reality:

- Much of the increased utilization of defined contribution systems in private industry was caused by the passage of the Employment Retirement Income Security Act ("ERISA").¹⁵ ERISA established standards for defined benefit plan participation, vesting, retirement, and reporting; and imposed a tax on defined benefit plans to fund the Pension Benefit Guaranty Corporation ("PBGC").¹⁶
- These changes reduced or eliminated incentives to private sector employers offering defined benefit plans, and increased the liability, expense, or regulatory requirements of maintaining a private sector defined benefit plan.¹⁷
- As a reaction to the importance of these new standards and costs, many small to midsized private sector businesses moved away from defined benefit systems toward defined contribution systems.¹⁸
- However, state and local government pension plans are not subject to most ERISA regulations and amendments.¹⁹
- Moreover, public plans are not required to make payments to the PBGC.²⁰
- As a result, the primary factor - ERISA - that pushed the private sector toward defined contribution plans does not even apply to state and local governments.
- Interestingly, even after the ERISA motivated shift to defined contribution systems in the private sector, costs of moving to a defined contribution system were so much higher than the potential tax burden under ERISA, large, private business predominantly continued to use defined benefit systems.²¹
- Fully 75 percent of the Fortune 500 still use defined benefit plans as their main retirement benefit system.²²
- Public sector employers are typically large employers.
- If large employers in the private sector still favor defined benefit systems despite the added costs and administrative burdens imposed by ERISA, there seems to be no reason for the public sector, which does not have those costs and burdens, to abandon defined benefit systems.
- This is especially so, given the higher administration costs that defined contribution systems would impose on taxpayers.

Harsh Realities:

- If contribution rates remained the same, defined contribution systems can be expected to generate significantly lower retirement benefits for greater costs. This was the specific experience of

15 Citing U.S. Department of Labor "The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans." <http://www.dol.gov/dol/topic/health-plans/erisa.htm#doltopic>.

16 Citing Pension Benefit Guaranty Corporation; "PBGC is a federal corporation created by the Employee Retirement Income Security Act of 1974. It currently protects the pensions of nearly 44 million American workers and retirees in 30,330 private single-employer and multiemployer defined benefit pension plans. PBGC receives no funds from general tax revenues. Operations are financed by insurance premiums set by Congress and paid by sponsors of defined benefit plans, investment income, assets from pension plans trusted by PBGC, and recoveries from the companies formerly responsible for the plans" <http://www.pbgc.gov/>.

17 Rajnes, David. "An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans" Employment Benefit Research Institute, pg 3, September 2002.

18Ibid.

19 Ibid.

20 Ibid.

21 Ghilarducci, Teresa.. "Future Retirement Income Security Needs Defined Benefit Pensions" Center for Economic Progress May 19, 2006.

22 "Government and Regulatory Initiatives Endanger America's Retirement Security" Association for Financial Professionals, March 18,2004.

Nebraska which switched to a defined contribution system 30 years ago and recently shifted back to a defined benefit system.

The Nebraska Experience:

- In the mid 1960's, Nebraska switched from a defined benefit to a defined contribution plan for state and county government employees.
- Immediately, that state noted it was paying higher administrative costs for its new, defined contribution system.²³
- Over time, Nebraska found that, when compared to its defined benefit plan, the new defined contribution plan cost the state significantly more in investment management fees, record-keeping fees, educational programs and other administrative line items.²⁴
- In 1999, Nebraska's administrative expenses for its defined contribution plans were double the costs of its defined benefit plans.²⁵
- Additionally, the state of Nebraska found that when employees managed their own investments under that state's defined contribution plan, investment returns were in fact lower than under the state's defined benefit system.²⁶
- During the period from 1983 to 1999, Nebraska state and county workers averaged a 6 percent return when investing their individual retirement accounts in that state's defined contribution plan, versus the 11 percent return for teachers and judges under Nebraska's defined benefit plan.²⁷
- The actual investment differential in favor of the defined benefit system becomes even greater once the lower administrative costs of the defined benefit system are factored in.²⁸
- One key reason public defined contribution plan returns lag defined benefit portfolios is simple, asset allocations made by employees in a defined contribution setting are often quite conservative.²⁹
- The Nebraska experience is illustrative.
- Despite state education programs on the importance of proper asset allocation and eleven different investment options, 90 percent of Nebraska's employees invested all their individual plan deposits in just three funds.³⁰
- This suggests employees lack the proper skills to diversify their assets and make sound investments.
- Under a defined benefit system, experienced portfolio managers invest plan assets under carefully considered asset allocation models geared toward long term returns.
- The bottom line was clear, Nebraska found that ten years after retirement, a retiree in that state's defined contribution plan with 30 years of service and an average annual salary of \$30,000, had about \$11,230 annually in retirement benefits,³¹ which is \$2,460 less than the poverty level for a family of two.

23 House Committee on Pensions and Investments, Texas House of Representatives, Interim Report 2000: A Report to the House of Representatives 77th Texas Legislature, p. 27.

24 Ibid.

25 Ibid.

26 Anderson, Gary W, and Brainard, Keith. Profitable Prudence: The Case for Public Employer Defined Benefit Plans Pension Research Council, The Wharton School, University of Pennsylvania. 2004.

27 Anderson, Gary W, and Brainard, Keith. Profitable Prudence: The Case for Public Employer Defined Benefit Plans Pension Research Council, The Wharton School, University of Pennsylvania. 2004.

28 Hawkins, Ronald L. The Nebraska Defined Contribution Plans: A Review of the State's Three Decade Plus Experience with Public Employee DC Plans. Defined Benefits.Org.

29 Ibid.

30 National Association of State Retirement Administrators, 2002.

31 House Committee on Pensions and Investments, Texas House of Representatives, Interim Report 2000: A Report to the House of Representatives 77th Texas Legislature, p. 26.

- Participants in Nebraska's defined benefit plan with similar pay and service credit, however, had an annual retirement benefit of \$16,797,³² which is \$3,100 more than the poverty level for a family of two.
- Faced with irrefutable data illustrating that defined contribution systems provide lower benefits for employees at higher costs to taxpayers, Nebraska legislators changed back to a defined benefit model in 2002.³³
- The state's duty to maintain pension benefit levels for its public employees is directly mandated in the Illinois Constitution.³⁴ The absolute nature of this responsibility means the unfunded liability cannot be legislated away; the debt must be repaid.
 - In fact, because the state is constitutionally required to provide retirees the benefits they earned, any proposed change to Illinois pension benefits can only operate on a *prospective* basis.
 - That means any legislation the state passes to reduce pension benefits will only apply to public employees newly hired *after* the change in law goes into effect.
 - Thus any significant savings from proposed changes to the state's pension system will not be realized for many years, until those new hires become a significant portion of the state workforce.
 - Because of this constitutional mandate, any change in the type or value of benefits offered public employees will in no way reduce the \$40.7 billion in accrued, unfunded pension liability.
 - *The only way the state can address this obligation is to develop a rational way to pay it over time, one that does not backload costs, and has a dedicated, sustainable revenue stream.*

³² Ibid.

³³ Ibid.

³⁴ Specifically, Article XIII, Section 5 of the Illinois Constitution provides, "Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." (emphasis supplied)