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## FROM DEFINED BENEFIT TO DEFINED CONTRIBUTION: STATE PENSION PLANS AND THE NEED FOR REFORM

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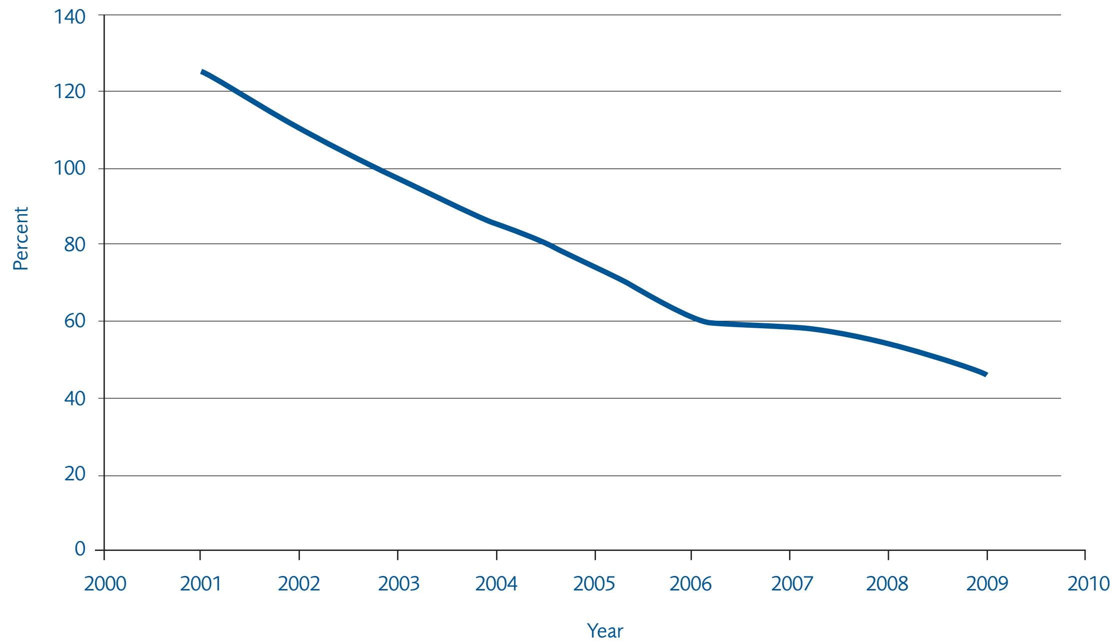
*We cannot continue. Our pension costs and health care costs for our employees are going to bankrupt this city.*
—New York City Mayor Michael Bloomberg[1]

*Pension reform can be hard to talk about. In the long run, reform now means fewer demands for layoffs and less draconian measures in the future. It's in the best interest of all Californians to fix this system now.*
—California Governor Jerry Brown[2]

Politicians and policy makers across the political spectrum widely agree that state public pension systems across America are broken. The benefit payout promises made to those nearing retirement have been broken again and again, as employees nearing retirement are asked to pay more of their health care costs, contribute more, and work longer in order to secure eligibility. Despite significant benefit reductions in recent years, the worst is still to come for the future retirees and youth now working in public pension systems. The recognition that there is a problem is the first step to recovery, so it is reassuring to see liberal politicians, like California Governor Jerry Brown and New York Mayor Michael Bloomberg and conservative politicians hammering at the idea that the current approach to public pensions is not sustainable.

While legislators agree that there is a problem, their reform ideas are varied and far-ranging. At one extreme, experiments, like those in Utah and Michigan, have replaced defined benefit pension plans with defined contribution plans. At the other extreme, in states like Alabama, Illinois, and Kentucky, legislators have chosen to plow ahead with temporary fixes to the system that will almost certainly prove to be too little, too late.

**FIGURE 1: FUNDING RATIO FOR KENTUCKY RETIREMENT**




*Source: Public Plans Database, Center for Retirement Research at Boston College*

## DEFINING CHARACTERISTICS OF PUBLIC PENSIONS

Defined benefit plans are the primary public sector retirement option for most state employees. Just 12 states offer workers some kind of hybrid or defined contribution option.[3] Since defined contribution plans are, by definition, fully funded, the financing problem faces primarily defined benefit plans.[4]

Funding ratios, which are the gold standard when evaluating the strength of defined benefit pensions, measure what the ratio of a pension is or an annuity's assets to its liabilities. When the ratio is above 1 (or 100 percent), the pension is able to cover all payments; when the ratio dips below 1, the plan is unable to make all payments promised to plan participants. In other words, the sum of all retirement benefits promised to all current and future retirees exceeds the asset value of the defined benefit trust.

Defined benefit plans often have funding ratios above 1, which means they are "overfunded." During the late 1990s stock-market boom, for example, many states had funding ratios of 120 percent.[5] Political incentives, however, tend to make high funding ratios a fleeting phenomenon. Time and again, healthy public pensions have been gutted by sweeteners, such as New Jersey's one-time increase in pension benefits of 9 percent in 2001, and a fattening up of promises to retirees.[6] Healthy, overfunded pensions can cover the costs of these extra benefits in the short-run. In the longer term, however, sweeteners and expansions devastate the pension's viability. Politicians, who consistently focus on short-term results because of their need for re-election, move forward with new and costly additions to retirement plans in the hope that such handouts will improve their electability.

Since 2001, funding ratios for public pension plans across the United States have declined from 100 percent to approximately 78 percent.[7] Yet the aggregate story of funding ratios, while troubling, masks many uglier underlying experiences. For example, the Kentucky Retirement System experienced one of the sharpest declines in funding ratios, dropping from 125.8 percent funding in 2001 to 46.7 percent in 2009 (see Figure 1).[8] The Alabama Teachers' Retirement System had a 100.2 percent funding ratio in 2001 and a 74.7 percent ratio in 2009.[9] The Illinois Teachers' Retirement System has experienced a funding ratio decline from 59.5 percent in 2001 to 39.1 percent in 2009.[10] Teachers in Illinois are already required to pay 9 percent of each paycheck into the Illinois teachers' pension fund,[11] and the low funding ratios make tax increases a certainty.

Rather than create an incentive for individuals to have concerns about their retirements and allow for a sense of ownership in their futures, the defined benefit systems makes retirement decisions collective. Plan administrators and politicians then go about overselling the benefits to members and can only maintain the programs long-term through coercive participation and ever-increasing contribution requirements. In addition to being supported by taxpayers, the plans are propped up by the people who leave programs early, the people who do not understand the program, and the young. Defined contribution plans are not free from problems, but they are superior when accounting for issues like the predictability of program costs and the opportunities for the political gaming of pension plans.

## POLITICAL AND ACADEMIC RESISTANCE TO REFORM

In Louisiana, employers (i.e., taxpayers) and employees are now making combined benefit contributions in excess of 30 percent to pension plans.[12] Across the United States, few plans have combined contribution rates lower than 20 percent.[13] (One cannot help but wonder what kind of nest egg could have been accumulated had just a fraction of these monies been placed into individualized accounts.) The high contribution rates are having adverse effects on state and municipal budgets—paying more into pension systems means buying fewer fire trucks, filling fewer potholes, and maintaining fewer city parks. Moreover, the high rates of taxation are creating strong disincentives for people to join the public labor force.[14]

Even though defined benefit programs are financially and intellectually bankrupt, some politicians and intellectuals continue to defend the idea. Common arguments made by both groups include that the costs of transition from defined benefit pensions to defined contribution pensions are too high. They also argue that shifting to defined contribution pensions could lead to capital flight and a loss of state dollars to support vital economic development initiatives because, once individuals have control over investment funds, they will focus on investing where expected returns are highest. In all likelihood, that will mean investing their capital in companies outside of their own state.[15]

Both arguments rest on shaky theoretical footing. The cost savings that defined contribution plans offer taxpayers vis-à-vis defined benefit plans could be enormous. Michigan, for example, has saved more than $4 billion since it shifted to defined contribution plans in 1997.[16] Utah, by capping the contributions it will make to its newly established defined contribution program, has reduced tax uncertainty for future payers and halted runaway increases in contribution rates.[17] The upfront costs of a switch—the costs of shifting current employees to a defined contribution while still finding revenues to deliver on promises to retirees—could indeed be costly. However, the long-term benefits of conversion are large enough that a one-time borrowing scheme or a program with sweeping one-time cuts in benefits to current and future retirees could finance the transition.

The capital flight concern places state prosperity above overall prosperity. The Alabama Teachers' Retirement System, for example, boasts that up to 15 percent of retirement contributions are reinvested in Alabama.[18] These dollars are said to attract investors and create jobs, but this statement is a classic case of hiding the "unseen" benefit behind the "seen," obvious benefit. Yes, these investment dollars create jobs. But at what cost? The dollars could have instead been earning higher rates of return in other investment ventures. Unless the Alabama dollars are truly reaping the highest overall return, the idea that dollars need to stay in Alabama rests on flawed economic reasoning.

Defined contribution plans are not free from problems, but they are superior when accounting for issues like the predictability of program costs and the opportunities for the political gaming of pension plans.

States should not be in the business of promoting economic development through taxpayer and retiree dollars. Instead, they should focus on creating sound business environments in which taxes are low and predictable, regulations are streamlined, and the legal code is interpreted consistently.

## CONCLUSION

America's fiscal mess, coupled with poor management in the past and changing demographics, guarantees that public pension systems across the country will be reformed. Some states will reform by cutting benefits, raising taxes, and tightening up eligibility requirements. Other states will follow the Utah model and implement more sweeping reforms. Two of the primary arguments against reform—high transition costs and capital flight—do not hold much intellectual water. At the margin, then, the case for more radical shifts from defined benefit to defined contribution plans is strong.

## ENDNOTES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2. Jerry Brown, "Jerry Brown Proposes Pension Reform," Brown for Governor Campaign, July 20, 2010, www.jerrybrown.org/node/965.

3. Alicia Munell, et al. "Why Have Some States Introduced Defined Contribution Plans?" *State and Local Pension Plans* 3, Center for Retirement Research at Boston College, January 2008.

4. This problem is not unique to the public sector. Many corporate defined benefit plans suffer from the same internal challenges.

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9. Ibid. Note: the author is a member of the Alabama Teachers' Retirement System.

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12. Jan Moller, "Gov. Bobby Jindal Proposes Tuition Increases, Consolidated Board in His Higher Education Overhaul," *Times Picayune*, January 31, 2011, http://www.nola.com/education/index.ssf/2011/01/bobby_jindal_proposes_tuition.html.

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14. The state of Georgia recognized the labor-force effects of its pension plan and subsequently introduced a hybrid model.

15. See Robert Holzmann, *Financing the Transition to Multi-Pillar*, Pension Reform Primer Series, Social Protection Discussion Paper 9809 (Washington, DC: World Bank, 1998), and David Miles, "Risk Sharing and Transition Costs in the Reform of Pension Systems in Europe," *Economic Policy* 14, no. 29 (October 1999): 251–86.

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