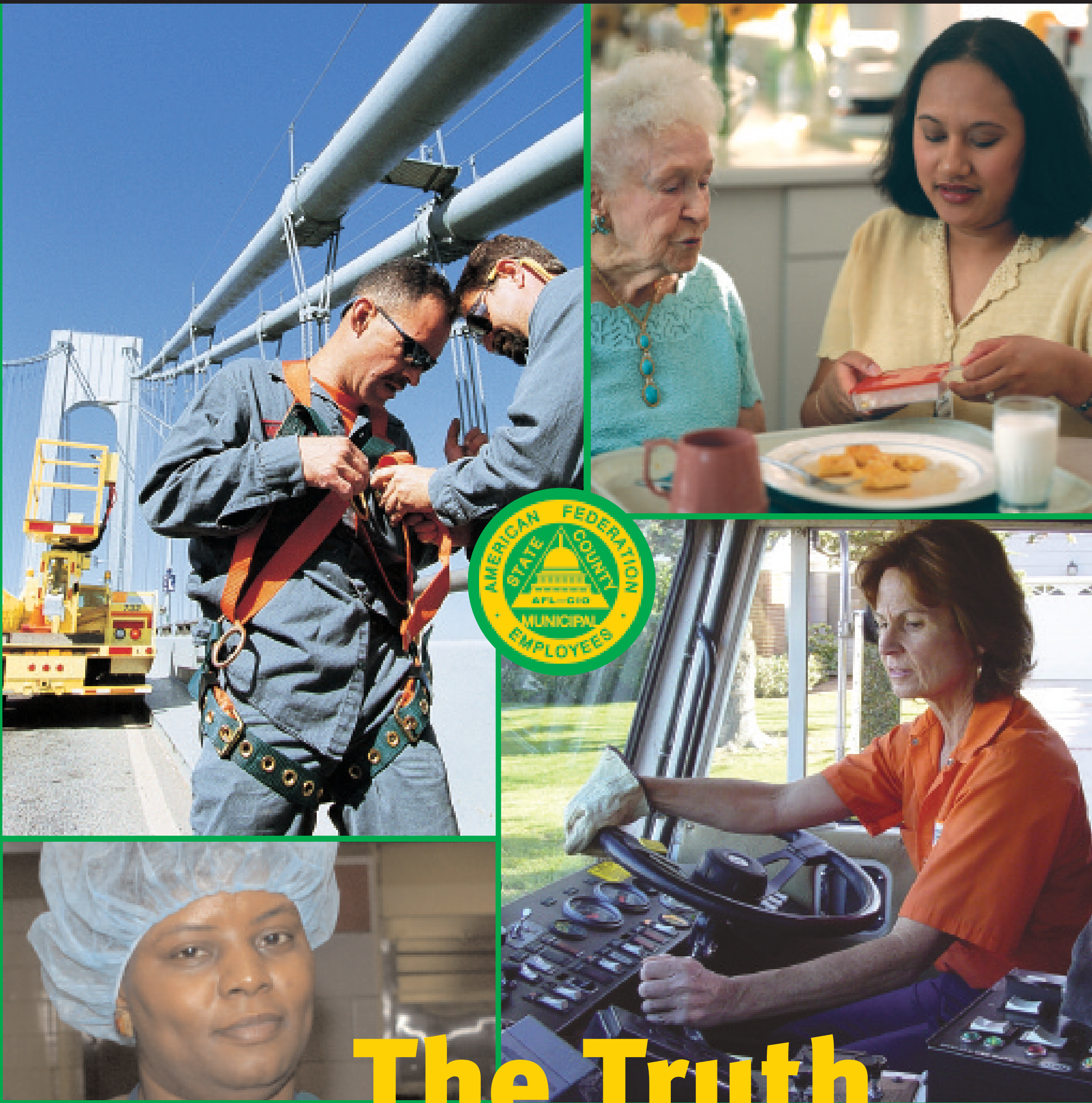
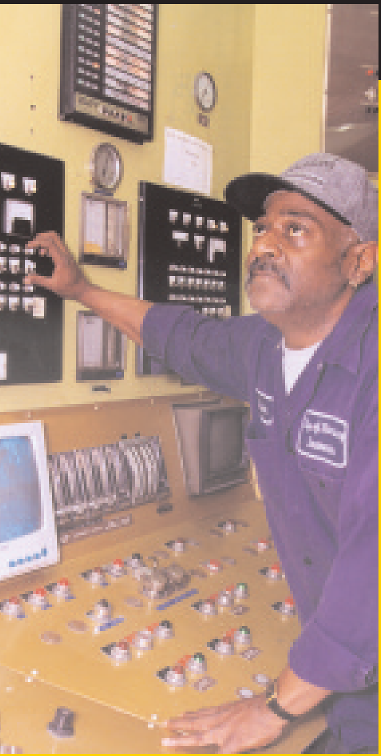


The Truth

About Public Employee Retirement Plans



Another Risky Scheme

A number of right-wing ideologues are trying to sell taxpayers a bill of goods. These individuals have claimed that public employee pension plans are an unfair and unaffordable drain on taxpayers.

They propose to replace the security of a promised retirement benefit, known as a defined benefit pension, with a risky defined contribution plan. What they don't say is that this massive change will cost taxpayers millions of dollars in administrative fees alone. And these administrative expenses will line the pockets of Wall Street brokers and other special interests as thousands of individual accounts are created to replace the larger pooled investment account in the current system.

Everyone deserves a basic level of retirement security after a lifetime of work. The current pension system delivers on that promise in a way that is fair to both taxpayers and employees.

What follows are answers to often-asked questions about this important issue.

Q: Aren't public employee pension benefits extravagant?

A: No. Public employee annuities are meaningful but modest. The average annual pension benefit for a retired public employee is approximately $19,500, which includes employees not covered by Social Security who rely solely on their pension for retirement income.

Q: Aren't defined benefit pensions a financial burden to taxpayers?

A: No. Employee contributions and investment earnings cover the bulk of defined benefit costs, while government contributions only cover 26 percent of the total costs. The truth is that the median pension contribution rate of public employees covered by Social Security is 5 percent of their pay, while the median pension contribution rate of public employees not covered by Social Security is 8.6 percent of their pay. In the private sector, on the other hand, 90 percent of plans don't require any employee contribution. Moreover, public employer contributions to pension plans are less than 3 percent of their total aggregate spending.

Q: Aren't defined contribution investment returns better than defined benefit investment returns?

A: No. Defined contribution investment returns are far below defined benefits plans' typical returns. Rates of return for professionally managed defined benefit plans outperformed employee-directed defined contribution plans by about 4 percent yearly during the 2000 to 2002 bear markets. In Nebraska, state officials felt that contributing to a defined benefit plan was a more efficient use of taxpayer money than contributing to individual defined contribution accounts, which only yielded 25 percent of pre-retirement income for plan members. Defined benefit plan participants were topping this by quite a lot, getting 60 to 70 percent of pre-retirement income.

Q: Aren't defined contribution plan fees and expenses lower than those of a defined benefit plan?

A: No. A defined contribution plan has an average $1.35 mutual fund charge for "load" and administrative expenses on every $100 invested, plus additional record keeping and participant education costs. This amounts to an annual cost of 2 percent of invested assets. In reality, this is ten times higher than the cost of administering a defined benefit plan. So even if defined contribution plan participants earn the same rate as defined benefit plan participants, they'd still receive a smaller benefit! Where does that extra money go? Wall Street.

Q: Aren't defined benefit retirement systems severely underfunded?

A: No. According to the most recent study, public pension plans have aggregate assets equaling 88 percent of liabilities. As recently as 2000, most of the largest plans were fully funded. Of course some retirement funds show a large, unfunded liability, but the shortfall isn't because of employees' failure to contribute – they do contribute. Rather it's from the government's failure to consistently fund these plans. The investment firm Merrill Lynch concluded that well-managed defined benefit plans are usually less expensive than defined contribution plans for employers over the long run.

Q: Aren't large, private-sector employers eliminating their defined benefit plans?

A: Yes. Many businesses have eliminated their defined benefit pension plans, but half of the 1,000 largest companies continue to offer defined benefit pensions. The businesses that have closed plans often cite the lack of coherent accounting and funding rules that are applicable to the private sector. Most of these rules are not applicable to public plans.

Q: Aren't defined contribution plans better for today's workforce?

A: No. The idea of a "nomadic" workforce is a myth – length of employee tenure is largely unchanged over the past two decades. In fact, retaining experienced staff is critical, and defined benefit plans are a key component of public employee compensation.

Q: Don't employees prefer defined contribution plans?

A: No. When given the option of switching to a defined contribution plan, workers by overwhelming numbers elect to stay in their defined benefit plan. In Florida and Michigan, more than 90 percent of those eligible to switch to a defined contribution plan stayed with the defined benefit plan. A similarly small number of Ohio's public employees enrolled in the state's defined contribution plan when that option was recently made available. Benefit experts agree that defined benefit plans are far superior to defined contribution plans for employees.

The Truth About Define

Defined contribution plans do not provide retirement security.

Defined contribution plans place all of the investment risk on the employee. No matter how much money an employee contributes, he or she has no idea how much money will be available at retirement. Defined benefit plans provide a known benefit and real security, regardless of what happens on Wall Street or how long an employee lives after retirement. Professionally managed defined benefit plans reduce investment risk and spread the risk over a large group. Plus, defined benefit plans often provide cost-of-living adjustments, and pension formulas are tied to an employee's salary at the time of retirement, protecting employees from inflation that creeps up during their work years.

Defined contribution plan participants have small fund balances.

The Employee Benefit Research Institute says the average balance of 401(k) participants at the end of 2004 was just over $58,000! Half of 401(k) participants have account balances of less than $20,000. Even more alarming is that those averages only include employees actually participating in their employer's plan. But 25 percent of workers who are eligible to participate in defined contribution plans do not do so. In fact, 40 percent of employees earning less than $40,000 annually do not participate.

Defined contribution plans are more likely to increase retirees' need for public assistance.

Because defined benefit plans provide a stable income for retirees – unlike defined contribution plans with their lump sums – participants are less likely to outlive their assets and rely on government programs, like Medicaid, when they retire. Policy experts are warning that many of today's workers won't be able to afford even a modest standard of living once they retire, especially if they get hit with major home health or nursing home bills, as many of them will. Defined contribution plans could lead to a rise in state Medicaid expenses, which are already a source of concern.

Defined contribution plans are NOT traditional pension plans.

Defined contribution plans are actually savings plans, part of what's often described as the ideal retirement formula – the three-legged stool of Social Security, a pension and individual savings. Defined contribution plans are designed to supplement a traditional pension, not replace it. Replacing defined benefit plans with defined contribution accounts may mean that a fourth leg needs to be added to support a wobbly retirement stool – continued employment!

Defined contribution plan assets are often used for purposes unrelated to retirement.

Those who are pushing defined contribution plans claim that those plans provide much-needed portability for today's workforce. But nearly half of all workers withdraw all of the assets from their 401(k) plans when they change jobs rather than roll them over to their new employer's retirement plan. These withdrawals not only erode an individual's retirement security, but result in a large tax payment and often a penalty for early withdrawal.

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