Defined Contribution Plans: Facts and Myths

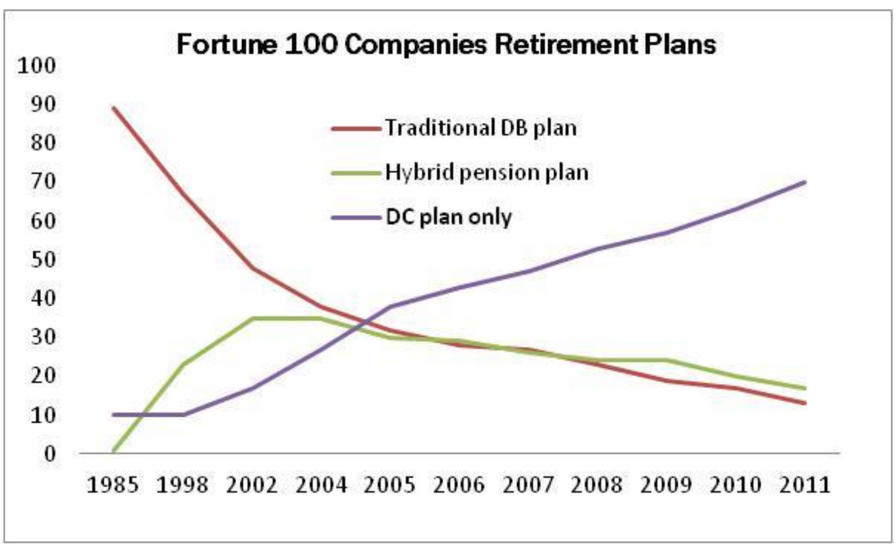
*Pennsylvania needs pension reform that provides state workers with a sustainable retirement system that's fair to new workers, existing employees **and** taxpayers. This publication addresses common myths and the benefits of switching new employees to a defined contribution, or 401(k) type plan.*

Myth #1: Defined benefit pension plans are better for taxpayers than defined contribution plans.

Fact: Defined benefit plans are inherently political. Defined benefit plans encourage lawmakers to increase benefits for current workers in good times, regardless of whether such benefits are affordable, and allows policymakers to push costs off onto future taxpayers in bad times. By contrast, defined contribution plans—which require a set contribution from employers and employees every month—make benefits predictable for taxpayers *and* workers.

The unsustainable and unpredictable nature of defined benefit plans is why private companies are rapidly abandoning such retirement systems. A survey by Towers Watson shows that Fortune 100 companies have overwhelmingly shifted to defined contribution plans.

These companies are also choosing 401(k) type plans over "hybrid" plans. Hybrid plans such as "cash balance plans," are defined benefit plans that incorporate aspects of defined contribution plans. While they offer less risk than traditional pensions, they suffer from the same funding and



political shortcomings which plague Pennsylvania's existing plans.

Since 2002, the number of Fortune 100 companies offering hybrid plans has rapidly decreased, while those offering 401(k) plans only **increased more than 300%**.

Myth #2: Defined contribution plans, such as 401(k)s, don't provide for an adequate retirement.

Fact: 401(k)s can be designed to provide a substantial replacement income at retirement when workers invest their entire careers. Evidence showing lower 401(k) income is based largely on workers who participated for only part of their careers.

Because 401(k) plans offer portability when changing jobs, they enable workers to maintain greater long-term control over their retirements. They can even be passed down to children or heirs, and—unlike Pennsylvania's present system—they cannot be raided or underfunded.

Myth #3: State pension plans cost less to administer than 401(k) plans managed by Wall Street firms.

Fact: A Deloitte study found that 401(k) plans cost the same or less than traditional plans to administer. SERS and PSERS spent more than $760 million last year on administrative costs and investment fees. As a percentage of assets, these costs exceed the average total fees for large 401(k) plans as calculated by Deloitte.

The fact is that Pennsylvania's troubled state pension funds *already* rely on expensive Wall Street investment firms to close looming deficits. For example, in 2006, the State Employees' Retirement System (SERS) gave $6 billion to six private investment firms to buy risky hedge funds in hopes of earning lavish returns to cover its pension shortfall.

Myth #4: Converting to a 401(k) pension system would create significant "transition costs."

Fact: Opponents claim government-mandated rules that require Pennsylvania to pay off unfunded liabilities sooner will cost the state, but the national Governmental Accounting Standards Board (GASB) regulates only the *accounting* methods—it doesn't mandate when or how debts must be paid. Taxpayers are already on the hook for the $40 billion unfunded liability for state and public school workers, and have to pay for that eventually. Switching to a new plan does not *add* to this liability.

Pennsylvania state government and school districts currently put less money into the pension plans than the "Annual Required Contribution" mandated under accounting rules. Regardless of reforms lawmakers may enact for new workers, the current funding system is unsound.

Myth #5: We must enroll new employees in the current system to reduce our pension liability.

Fact: State pension plans are not funded like a Ponzi scheme. An employee's contribution is only for his or her own retirement. A teacher's contribution, for example, does not even cover the full estimated "normal cost" of his or her pension. Taxpayers (the school district and state) pay an additional cost per employee based on assumptions of workers' retirement age and investment returns. The unfunded liability is entirely borne by taxpayers, and must be paid off regardless of pension design changes.