Advantages of Defined Contribution Plans

By Peter J. Ferrara
Americans for Tax Reform

Advantages to Workers

Portability. The most obvious advantage of defined contribution plans for workers is portability. Since the contributions are paid directly into individual accounts for each worker, it is easy simply to allow workers to take their accumulated funds with them when they change jobs. As a result, workers get to keep the full past contributions made on their behalf and their full accrued benefits. In a defined benefit plan, by contrast, the contributions for each worker are in a common pool where each worker's share is not separately identified. Because of vesting requirements and other features of the benefit formula, withdrawals and other payments from the common pool for workers who depart before attaining long term service do not reflect their fair share of past employer contributions, as discussed further below.

Immediate Vesting. In a pure defined contribution plan, the employer's contributions to the individual account become the full property of the worker upon payment. As a result, the worker enjoys immediate vesting of employer retirement contributions. This greatly benefits the majority of state and local government workers who are not going to stay with one employer for the rest of their careers.

In a typical defined benefit plan, by contrast, the employer contributions are again kept by the government in a common pool, and the worker's rights to them typically vest only after long periods of 10 years or so. As a result, most workers lose out, as most remain with one state or local employer for less than 10 years. For example, in California 70% of state and local workers lose all employer retirement contributions because they stay with one employer for less than 10 years, and consequently fail to meet the 10 year vesting requirement. Moreover, even workers who stay longer do not receive the full benefit of the employer contributions until they have worked well beyond 10 years.

Personal Control. In the defined contribution plan, the retirement funds for each worker are under the control of the worker in their own individual accounts. Workers can consequently adopt the investment strategies and benefit plans that best suit their own individual needs and preferences. As a result, they may well end up with higher benefits than under a traditional defined benefit plan, as discussed further below. Moreover, under the defined contribution plan they don't have to worry about politicians taking away benefits or bureaucrats mishandling funds and losing their retirement assets.

Fair Benefits. Under a traditional defined benefit plan, the benefits are skewed to favor the longer term and oldest workers over others, in at least 3 ways. First, the vesting requirements eliminate benefits for those working less than 10 years or so, with the funds then devoted to the longest term workers. Secondly, the benefits are a percentage of final salary, which tends to be much higher for those who have worked for the employer the longest, or for older workers.

Thirdly, granting the same percentage of final salary for each year worked (1%-2%) does not grant the full benefit of the contributions for younger workers who remain employed for several years, then leave. For example, take a worker who enters government employment at 22, works for 15 years, and then leaves for a private sector job. Under a traditional defined benefit plan, he will qualify for benefits when he reaches retirement. But he will only receive the same 1%-2% of final salary for each year worked as other workers under the benefit formula. Yet, the contributions paid for him during employment continued to earn investment returns for many years after he left employment. The worker, however, receives no benefit from these additional investment returns.

Indeed, contrast this younger worker with an older worker who enters government employment at age 50 and continues to work there for 15 years., retiring at age 65. The contributions for this worker earned investment returns for far fewer years than those for the younger worker. Yet, this worker will get the same 1%-2% of final salary for each year worked as the younger worker. If the older worker's salary was higher, as is likely, he will actually get more benefits in retirement than the younger worker, even though the contributions for the younger worker earning returns for many more years would have accumulated to much more by retirement. The younger workers are consequently denied the full benefit of their contributions, which are redistributed in large measure to others.

None of these distortions occur in a standard defined contribution plan. The contributions to the worker's account immediately vest as the property of the worker, so the worker gets to keep those full contributions in any event. The worker also gets to keep the full returns earned by those contributions over the years, rather than leaving them to others based on a calculated percentage of final salary. The defined contribution plan consequently provides fair, undistorted benefits to each worker, granting each the full value of the contributions made for them.

Higher Benefits. The defined contribution plan includes no limit on the benefits workers can receive. Those who achieve strong investment performance in their individual accounts will receive substantially higher benefits than offered under a standard defined benefit plan. In fact, there is good reason to believe that on average workers in defined contribution plans will receive substantially higher benefits than offered by defined benefit plans.

Those managing the common investment pool for a defined benefit plan are investing only to finance the targeted benefit levels. For career workers, these will range from 30% to 80% of final salary and cluster around 45%-65%.[2] The managers will not invest more aggressively to achieve higher benefits, even when that can be done safely. If they do attain higher investment returns, the employer will likely reduce contributions or withdraw the excess assets.

Contributing a standard 10% of salary each year to a defined contribution plan that earns the full standard investment returns available in the market will produce higher benefits than those targeted under a typical defined benefit plan. And those who would benefit the most are the longest term workers who thought they were getting the most out of the skewed benefits of defined benefit plans.

The average real rate of return earned in the stock market going back over the last 70 plus years, all the way back to 1926, is 8%.[3] The average real rate of return on corporate bonds over that period is 3% or more.[4] A conservative portfolio with half of each would earn 5.5%

Assume a worker who earns around $30,000 per year over his career in constant inflation adjusted dollars. If 10% of that salary is contributed to a personal investment account for the worker earning a real return of 5.5% each year, then after 40 years that investment account would total $432,357, again in constant, inflation adjusted dollars. (See Table I) That amount would finance an annuity paying about $60,000 per year each year for the rest of the worker's career. A defined benefit plan paying 1.5% of final salary for each year of work would pay only $18,000 per year. A defined benefit plan paying 2% of final salary for each year of work would pay only $24,000 per year. So the defined contribution plan would pay 2 ½ to 3 ½ times the benefits of the defined benefit plan. (See Table 1)

A worker's earning $40,000 each year would reach retirement after 40 years of work with a retirement account total of $576,476, again in constant dollars. That amount would finance an annuity of $80,000 per year, compared to $24,000 - $32,000 for a defined benefit plan. A worker earning $50,000 each year would retire with a fund of $720,595, paying about $100,000 per year, compared to $30,000 to 40,000 for a defined benefit plan. Again, the defined contribution benefits are 2 1/2 to 3 ½ times the defined benefit plan payments. (See Table 1).

Now suppose the worker retires after only 30 years of work. At a salary of $30,000 per year, the worker would retire with a fund of $313,457, which would pay about $43,000 per year in benefits compared to $13,500 to $18,000 for a defined benefit plan. The defined contribution benefits are still 2.4 to 3.2 times the defined benefit plan payments. (See Table I). The $40,000 per year worker would retire after 30 years with a fund of $ 417,942, paying about $58,000 per year in benefits, compared to $18,000- $24,000 for the defined benefit plan. The $50,000 per year worker would retire after 30 years with a fund of $522,428, which would pay about $73,000 per year, compared to $22,500 - $30,000 in the defined benefit plan. (See Table I) Again, the defined contribution plan pays 2.4 to 3.2 times the defined benefit plan.

Now suppose the worker's retirement account doesn't perform as well as others for some reason and earns only a 4 % real return, which is just half the average return in the stock market over the last seventy years. A $30,000 per year worker would retire after 40 years of work with a trust fund of almost $300,000. That fund would pay almost $37,000 per year for the rest of the worker's life, again all in constant, inflation adjusted dollars. The defined benefit plan would pay $18,000 - $24,000 per year. (See Table 2) So the defined contribution plan would pay 50-100% more.

A $40,000 per year worker would retire after 40 years with a trust fund of almost $400,000, which would pay almost $50,000 per year, compared to $24,000 - $32,000 for the defined benefit plan. A $50,000 per year worker would retire with a trust fund of almost $500,000 per year paying over $61,000 per year, compared to $30,000 to $40,000 for the defined benefit plan. (See Table 2) In these cases, the defined contribution plan again pays 50-100% more than the defined benefit plan.

Now suppose the worker's retires after only 30 years. The $30,000 per year worker would retire with a trust fund of about $175,000, paying about $21,000 per year, compared to $13,500 to $18,000 for the defined benefit plan. The $40,000 per year worker would retire with a trust fund of $233,000 paying about $28,000 per year, compared to $18,000-$24,000 for the defined benefit plan. The $50,000 per year worker would retire with a trust fund of almost $300,000, paying about $36,000 per year compared to $22,500 to $30,000 for the defined benefit plan. (see Table 2). The defined contribution benefits are still substantially more than the defined benefit plan payments.

These calculations all assume retirement at the standard Social Security retirement age, which is 65 today and will rise to 67 over the next 25 years. To the extent workers can receive retirement benefits under the defined benefit plans at earlier ages those plans would do much better compared to the defined contribution plans. But such defined benefit plans also require much higher contribution rates than 10% of salary, which was used as the basis for the defined contribution benefits alone. At a minimum, however, these calculations show that the longer term workers would do quite well under defined contribution plans, and would quite possibly receive significantly higher benefits than under a typical defined benefit plan.

Freedom of Choice: Finally, the defined contribution reform proposals maximize the freedom of choice of workers. Under the defined contribution plans, workers can choose their own investments, investments strategies, and investment managers. They can also choose their own benefit structures and vary their benefits over time, perhaps leaving more in the accounts to accumulate further earnings. Current workers can also choose whether they want to be in the defined contribution plans or stay in the defined benefit plans, and under most proposals this is true for future workers as well. The bottom line is that the defined contribution reform proposals give workers maximum freedom of choice and control over their own money.

Advantages for Taxpayers

No Investment Risk: The most obvious advantage for taxpayers of a defined contribution plan is that it eliminates investment risk for them. With the government managing a common pool of investment funds under a defined benefit plan, the taxpayers bear the complete risk of poor investment performance. If such poor performance leaves the pool unable to pay the promised defined benefits, then the taxpayers will have to make up the difference.

Under the defined contribution plan, however, the taxpayers simply make a specific contribution to the accounts of the workers each month. The government is then not liable for the investment performance of the funds. Workers' benefits equal whatever the accumulated funds can finance. Taxpayers consequently are not subject to any risk of investment performance.

No Political Risk: Defined contribution plans eliminate another set of risks that are usually overlooked - political risks. With the government specifying benefits far in the future, as under defined benefit plans, there is always a strong danger of political giveaways by short-sighted politicians. These politicians can promise higher retirement benefits, while leaving future officials and taxpayers to pay for them. Under a defined contribution plan, where the government

does not specify future benefits but only makes regular investment contributions, this risk is eliminated.

Moreover, a large government investment pool, as under a defined benefit plan, is always subject to the danger of political interference that could raise costs. Political favoritism may influence investment policy, prohibiting some investments and forcing the fund into others. By taking the focus off of simply maximizing investment returns, such political favoritism will reduce investment returns and increase the cost of funding the specified defined benefits.

Politicians may seek to raid the large, tempting investment pool in other ways as well. They may seek to withdraw funds for other uses, claiming an excess of funds which may be temporary or chimerical. Or they may try to use the funds for short-term added benefits. These actions would again raise costs for taxpayers.

Government management of the funds also creates the risk of mishandling of the funds by bureaucrats who lack the incentives, competitive pressures, and expertise of private investment managers. Attempts to insulate the funds from bureaucratic control by contracting out to private investment managers may not be entirely successful.

Finally, a large government investment pool creates the risk for taxpayers of greater government control of the private economy. Through such a pool, the government may end up owning large shares of private companies. The government would also hold a large share of investment capital that it could use to impose mandates on the private sector. Even where there has been a good record of avoiding such abuse in the past, the danger is always present.

None of these risks arising from a large government investment pool exist in a defined contribution plan, where the government does not maintain such a pool.

No Unfunded Liability. The defined contribution plan also eliminates the danger of any unfunded liability that must be covered by taxpayers. Under a defined benefit plan, any shortfall in the common investment pool that leaves the pool unable to pay the promised benefits, creating an unfunded liability, must be covered by the taxpayers, regardless of the cause of the shortfall. In the defined contribution plan, where the government does not maintain a common investment pool but only pays a specified amount to each worker's individual account each month, and benefits equal what those accounts can finance, there is no possibility of an unfunded liability that taxpayers would have to cover.

Greater Control Over Costs. The defined contribution plan also provides the government and taxpayers greater control over costs. Costs under a defined benefit plan, where the government has pledged to provide a certain benefit regardless of cost, can vary greatly, depending on a wide range of factors outside the government's control. Retirees can live longer, greatly increasing costs. More workers may stay with the government employer long term, increasing costs. Interest rates or the stock market may decline, requiring increased contributions to make up the difference.

A defined contribution plan by contrast, the government is responsible only for a specified contribution each year. This is completely under the government's control, depending only on what the government agrees to pay. This means in turn greater certainty and predictability in budgeting. There is no possibility that taxpayers will be surprised with a large, unexpected cost that will require increased taxes.

Reduced Costs. A defined contribution plan can also significantly reduce costs. Defined benefit plans have large administrative costs for the government employer. The government must maintain and pay for the management of the large common pool of assets. Moreover, federal law imposes many regulatory requirements on such plans, regarding distribution of benefits, eligibility, investment policies, etc. Complying with and reporting on these requirements significantly adds to costs.

With a defined contribution plan, by contrast, administrative costs are negligible. The government simply pays an amount into each employee's own account as part of payroll processing. The worker takes over administration of the account after that.

A defined contribution plan may save the government on funding cost as well. The discussion above showed that workers can get high benefits, paying more even than their final salaries, with only 10% of salary paid into the individual defined contribution accounts. Indeed, these benefits can be substantially higher than under typical defined benefit plans. Yet, such plans typically cost more than 10% of payroll. With a defined contribution plan, government employers may be able to get a better deal for their workers while paying less into the plan.

In California, the state Department of Finance estimated that the defined contribution plan offered by Assemblyman Howard Kaloogian would save the state's taxpayers $1,642 per employee each year, due to the above factors. That adds up to a very large benefit for taxpayers.

Improved Employee Recruitment. Finally, because of the advantages to employees noted above, defined contribution plans can help employers attract better employees. Highly talented workers may not be willing to commit to state government employment long-term. But they may be willing to work for a state or local government for a few years. The defined contribution plan would make it easier to recruit such workers because it is fully portable, and the workers can take the saved contributions with them when they leave. Moreover, these and other workers would favor the freedom of choice, personal control, and possibly higher benefits that they could get through defined contribution plans.