Defined Contribution vs. Defined Benefit Retirement Plans

IEA Position – OPPOSED TO DEFINED CONTRIBUTION

Background

A **defined contribution (DC)** plan is like a 401k. In a defined contribution plan, the amount of money contributed by the employer and employee is specified while the retirement benefit earned by the members is based on the investment performance of those contributions at retirement. In DC plans members are given mutual funds or tax-deferred annuities as options to invest their money. A 403b is also an example of a DC plan.

Defined benefit (DB) plans specify a certain benefit for the member at retirement based on several factors. Most DB plans are based on length of service and final average salary multiplied by a certain percentage. In the Teachers' Retirement System (TRS) and the State Universities Retirement System (SURS), the percentage is 2.2% for each year of creditable service.

Why Change?

Proponents of defined contribution plans list the following advantages: portability costs, no unfunded liability and improved investment return. The real reason, however, may be that DC plans limit the risk and the cost of the employer or the state. In DC plans, the employee assumes all the risks of investing; while in DB plans, the employer or the state with the help of investment professionals assumes all the investment risk. In Illinois our retirement benefits are also protected by the Illinois Constitution. Whereas, the benefits of a DC plan are solely reliant on the stock market and are not protected by the Illinois Constitution.

Reasons for Opposition

- **No Social Security Benefits-**Teachers and those employed at our Universities receive *NO Social Security benefit* in retirement for their years of employment in those areas. This means that under a defined contribution plan their sole retirement would be reliant upon a tremendously volatile stock market. This is a huge distinction between public school teachers and private sector employees.

- **DC Is More Expensive than DB-**Private sector employers that offer either a pension plan or a defined contribution plan (401k) pay 7.65 percent in Social Security and Medicare taxes, plus 3 percent[1] or more for either a 401k plan or a pension plan for employees. This brings the total cost to almost 11% for most employers. *TRS will only cost the state 6.63% of salary in the coming years.*

  1. "51st Annual Survey of Profit Sharing and 401k Plans," Published By: Profit Sharing/401k Council of America.

- **A Pension Switch Will Not Solve the Pension Funding Problem-**The current $75 billion unfunded pension debt will still have to be paid if there was a new defined contribution plan. That debt cannot be erased because the state constitution specifically prohibits any decrease in benefits for people currently in the retirement systems.

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Case Study

- Nebraska shut down their DC plan after discovering the DB plan investment returns doubled that in the DC plan.

- A study in West Virginia confirmed that a properly-funded DB plan is cheaper than a DC plan with equal contributions.

Risk of DC plans

- Defined contribution plans shift the risk from the employer/state to the employee. If the employee invests poorly, the employee suffers at retirement.

- 45% of employees who left their jobs in 2004 cashed out their 401ks; 42% of employees age 40-49 cashed out.

- Outliving your assets, investment mistakes or market decline, outliving your savings (mortality risk). Buying into an annuity is a very expensive way to avoid mortality risk.

- Administrative expenses – The median cost of a DC plan is $1.40 for every $100 invested. This is according to the National Association of State Retirement Administrators.

- DC plans have high educational costs, especially at transition ($55 million budgeted in Florida.)

Benefits of a DB Plan:

- Reward for long-term employees – Defined Benefit plans are typically based on final average salary, thereby rewarding long-service employees. The average TRS annuitant has 29 years of service.

- Additional benefits in DB plans – Most defined benefit plans provide additional benefits not provided in most DC plans like the following: guaranteed post-retirement increases (COLA), service credit for sick leave, military leave and maternity leave, early retirement, survivor's benefits and disability benefits.

- TRS's administrative and investment expense is extremely low. It only costs $0.30 per $100 in TRS assets to run the pension plan.

Balanced Approach

We believe that the correct approach is to have a retirement package that includes all of the following:

- Defined benefit retirement plan(s) – current state retirement plan and/or social security.

- Optional defined contribution plans – current tax-deferred annuity plans.

- Post-retirement Health Insurance.