Less Bang for Pennsylvania’s Buck

Governor’s Pension Proposal Would Force Taxpayers (and Employees) to Foot the Bill for Retirement Plans with High Fees, Low Returns

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Keystone Pension Primers: As Pennsylvania policymakers, media, and citizens evaluate Governor Tom Corbett’s pension proposal, the Keystone Research Center continues to release “pension primers” to demystify the often complex details at the heart of the pension debate. This is the seventh pension primer.

This week, the Senate Finance Committee is expected to consider legislation that contains portions of Governor Tom Corbett’s pension proposal. One element of the Governor’s plan that appears to have significant support is his proposal to switch future teachers, emergency responders, nurses, and other school and state employees from the state’s current defined benefit pension system to 401(k)-type individual retirement accounts. This pension primer compares the efficiency, or cost-effectiveness, of individual accounts with the state’s current retirement plans. It finds that the Governor’s plan forces taxpayers and employees to foot the bill for retirement plans that are much less cost-effective than the state’s current defined benefit pensions.

The efficiency gap results primarily from three factors:

• Lower investment returns typically earned on individual accounts compared to professionally-managed defined benefit pensions.

• The cost to individual account holders of ensuring that they don’t run out of savings if they live an unusually long life. Individuals may pay this cost by buying an “annuity”—converting their savings into a fixed payment that continues until they die—or by “oversaving” compared to the funds needed if they live the normal life expectancy.

• And the administrative, financial management, and trading fees charged by financial firms when they invest portions of individual account holders’ assets. As a result of these fees, Wall Street would get more money (in profits) but Main Street Pennsylvania would receive less money (in retirement checks).

According to two recent studies that explicitly model the cost of achieving a specific level of retirement security for specific types of employees (with specified years of service, salary, target replacement income, life expectancy, etc.), defined contribution plans cost 57% to 83% more than defined benefit pensions.

The superior performance of defined benefit pensions is also supported by empirical evidence on investment returns.

• According to the human resources firm Towers Watson, defined benefit plans have had investment returns about three-quarters of a percentage point higher annually since 1995.

• In Florida, where public employees can participate in a state-administered defined contribution account or the state’s defined benefit pension, the Keystone Research Center found that the investment returns of the defined benefit pension were also 76 basis points higher than the returns on individual accounts.
Key Facts About Pennsylvania Pensions

While each “Keystone Pension Primer” focuses on one issue in the pension debate, lawmakers, members of the media, and the public should consider all issues in evaluating the Governor’s proposal:

• The Governor’s proposal would increase Pennsylvania’s pension debt (or “unfunded liability”) by tens of billions of dollars, according to actuarial studies.

• The Governor’s proposal would increase the cost of pensions for new employees above the low levels (3% on average for PSERS and SERS combined) resulting from Act 120 of 2010, a cost of more than $2 billion over three-plus decades, according to actuarial studies.

• By “lowering the collars” (the increase in state pension contributions over the next five years), the Governor’s proposal does not make the responsible contributions to pensions required by Act 120, increasing Pennsylvania’s pension debt by roughly $4 billion by 2020. Lowering pension contributions is a replay of the short-sighted political decisions that helped create the current unfunded liabilities.

• The Governor’s proposal to cut current workers’ pensions risks court reversal for violation of a constitutionally protected contract. It leaves the state uncertain of pension costs for years and with potentially higher pension debt.

• Teachers, nurses, emergency responders, and other public employees contribute heavily to their own pensions and earn lower salaries than comparable private-sector workers. School and state employees currently contribute 7% of every paycheck, on average, to their own pension—and contributed 3.4 times as much, relative to employers, as public employees in other states from 2001 to 2011. Even with good benefits, Pennsylvania public workers earn lower wages plus benefits than equivalent private-sector workers.

• The Pension Reform Act of 2010 reduced pensions for future employees by over 20% and protects taxpayers through a unique “shared risk” feature that requires even higher employee pension contributions if financial markets plummet.

• Pennsylvania’s pension debt should be kept in perspective compared to the overall budget and the rise of income inequality in the state. Pension debt is a small share of total state funding over the decades the state has to pay it off. In addition, Pennsylvania’s “99%” lose each year an amount roughly equal to the pension debt (now $47 billion) because the richest 1% garners more of the overall economic pie than in the 1970s.

401(k)-Type Individual Accounts Are Less Cost-Effective Retirement Plans

The Governor and some lawmakers favor switching future Pennsylvania state employees from the current defined benefit pensions to 401(k)-type individual retirement accounts. As lawmakers and the public consider this option, it is critical for them to understand just how much less cost-effective individual accounts are.1 This efficiency gap results primarily from three factors.

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**Defined Contribution Plans Come with High Fees**

Fees for administering and managing retirement plans reduce the money available to pay retirement benefits. Robert Hiltonsmith of the nonprofit think tank Demos divides these fees into four categories: administrative, marketing, asset management, and trading. Hiltonsmith works through a numerical example of the impact of fees on retirement savings based on an actual equity fund into which Demos’ 70 employees may put some of their individual account savings. Hiltonsmith finds that fees eat up about one half of inflation-adjusted investment earnings.

Defined benefit plans typically have much lower fees than individual savings accounts because they pool assets. When defined benefit plans use their own professional managers to manage funds, the costs are spread over many more assets; and when they hire outside firms to manage assets, they have the leverage to negotiate low fees. Researchers at Boston College find that asset management fees average only 25 basis points for public sector defined benefit plans but 60 to 170 basis points for private-sector defined contribution plans. Since scale influences administration and management costs, a state-managed defined contribution plan in a large state such as Pennsylvania could achieve costs closer to defined benefit plans than small defined contribution plans can. However, defined contribution plans have some costs associated with individual recordkeeping, individual transactions, and investment education that defined benefit plans do not have. The only unique cost borne by defined benefit plans is the administrative cost of making regular monthly payments after retirement.

**Defined Benefit Plans Pool ‘Longevity Risk’**

Defined benefit plans also outperform defined contribution plans because they pool “longevity risk.” Each of Pennsylvania’s defined benefit plans has hundreds of thousands of members, so those who live longer-than-expected lives are balanced by those with shorter life spans. While plan managers cannot know how long each participant will live, they can know with precision the average life span over which retirees will receive pension checks. Thus, the plan can build up precisely the assets needed for each retiree to receive a pension check until he or she dies.

When individuals save for their own retirement, they have to save for more than the expected (or median) number of years that they are projected to live in retirement. If they don’t, about half will run out of savings before they die (because about half will live longer than the median life expectancy). To be safe, defined contribution account holders need to save enough so that their savings last even if they live much longer than typical. The National Institute on Retirement Security (NIRS) estimates that this requires defined-contribution retirement plan participants to save 15% more than is needed in a defined benefit plan. Alternatively, defined contribution account holders could buy an “annuity” from a financial services firm, converting their lump-sum savings into a promise of a fixed monthly payment that continues until they die. But financial firms selling annuities charge more for the annuity (i.e., provide a smaller monthly check for a given upfront payment) in order to protect themselves against the possibility of the person living much longer than normal. Therefore, retirees get a lower guaranteed monthly amount than they would with the same amount of savings in a pooled defined benefit plan.

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On Investment Returns, Defined Benefit Pension Plans Beat 401(k) Savers Silly

Defined benefit plans achieve higher investment returns than defined contribution plans because professional managers invest the assets. These managers typically have broadly diversified portfolios and follow a long-term strategy. As noted by NIRS, “...individuals in [defined contribution] plans, despite their best efforts, often fall short when it comes to making good investment decisions.” In addition, defined benefit plans typically have a balance between younger and older workers and retirees, and therefore can maintain a balanced portfolio at all times. In defined contribution plans, individuals face increased risk to financial market shocks as they age. To avoid a sudden plunge in the value of their savings, they ordinarily shift to more conservative portfolios as they near retirement. While they gain increased security, this shift erodes the aggregate performance (i.e., investment returns) of defined contribution plans.

NIRS (p.12) cites three sources that put the defined benefit investment return advantage over defined contribution accounts at between 80 and 180 basis points (each 0.01% is a basis point; for example, the difference between a 7% return and an 8% return is 100 basis points). A May 2013 brief released by the human resources firm Towers Watson found that defined benefit pension plans outperformed defined contribution plans by nearly three percentage points in 2011, and by 76 basis points from 1995-2011. Among the largest one-sixth of plans, the group into which Pennsylvania’s pension plans fall, defined benefit pensions outperformed defined contribution plans by 99 basis points—nearly a full percentage point.4

A “natural experiment” exists in a small number of states in which the state manages both defined contribution and defined benefit plans. How do investment returns and plan costs compare over the same period of time when the same retirement plan agency manages both types of retirement plan options? In Florida, the Keystone Research Center found that, net of reported plan costs, the investment returns of the defined benefit pension were 76 basis points higher than the aggregate of the individual accounts. While 76 basis points sounds small, it adds up over time because of compounding effects. In Florida’s case, the 76 basis point difference in investment returns, along with a small cost advantage for the state’s defined benefit plan compared to its defined contribution plan, resulted over a 30-year period in a 51% higher growth in inflation-adjusted savings in the defined benefit plan.

In another revealing natural experiment, Pennsylvania’s 401(k)-type “457 plans,” managed by the State Employees’ Retirement System (SERS) for state workers, have earned only 6.1% on average since their inception over 30 years ago.5 This is far below SERS’ defined benefit plan rate of return over this same period.

The Overall Cost Gap: Defined Contribution Plans Cost 57% to 83% More

Taking into account all the factors that increase the cost of defined contribution plans, NIRS estimates that it would cost 22.9% of payroll to achieve the same level of retirement security provided by contributions of 12.5% of payroll in a defined benefit plan—that is, the defined contribution plan would cost 83% more to deliver the same level of retirement security. A more recent report estimates defined benefit vs. defined contribution costs in New


5 In fact, the SERS website defines the term “defined contribution plan” as follows (emphasis added): “A tax-favored investment plan in which you voluntarily defer part of your current income to a future date (retirement) to avoid taxation until the monies are distributed (e.g., The Commonwealth of Pennsylvania's Deferred Compensation Plan (SERS' 457 Plan)).” Online at http://www.sers.state.pa.us/portal/server.pt/community/glossary/14380#d.
York to provide the same level of retirement security for five different sample employees: it finds that individual accounts would require 57% to 62% higher contributions.\(^6\)

**Question:** Why should Pennsylvania incur large transition costs associated with closing defined benefit pension plans in order to force employees and taxpayers to participate in substantially less cost-effective retirement savings plans?

**Answer:** It shouldn’t.

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The Keystone Research Center is a nonprofit, nonpartisan research organization that promotes a more prosperous and equitable Pennsylvania economy. Learn more: [www.keystoneresearch.org/pensions](http://www.keystoneresearch.org/pensions).

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