# Debunking the Defined Benefit Cost-Effectiveness Myth

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Based on a forthcoming paper from the Manhattan Institute (available on 8-11-15)
http://www.manhattan-institute.org/html/cr_100.htm

# Retirement Benefits Are Important

- Everyone who works hard and plays by the rules should have a retirement plan that puts them on the path to retirement security.

- Retirement benefits are an important and valued part of workers' compensation.

- Promoting workforce-wide retirement security is a worthy public policy goal.

# No One-Size-Fits-All Solution

- All plan designs can incorporate basic elements that support retirement security.
  - Adequate savings/benefit accrual rates
  - Pooled, professionally managed, low-fee, and appropriately allocated investments
  - Limited lump sums and favorably priced annuities upon retirement

# What Do the Basic Plan Categories Mean?

- While there is significant variation within each category, under a typical:
  - Defined-benefit plan (DB), workers are promised a monthly retirement benefit based on salary, age, and years of service.
  - Defined-contribution plan (DC), workers are promised annual employer contributions to individual accounts.
  - Cash balance plan (CB), workers are promised annual employer contributions and a minimum investment return.

# What Are the Benefits of CB and DC?

- While all plan types can be designed to incorporate important features for retirement security, CB and DC plans:
  - Are fair to all workers;
  - Represent the simplest, most transparent models for providing secure retirement benefits; and
  - Reduce/eliminate the potential for pension debt to undermine public finances and benefit security.

# The Myth of DB Cost-Effectiveness

- When state and local governments have considered DC plans, they have encountered opposition from the leaders of organized labor, current public retirement system managers, and the cottage industry of consultants who rely on public DB plans for work.

- These groups generally claim that DB plans have inherent advantages, resulting in better benefits at a lower cost.

- National Institute for Retirement Security (NIRS), a Washington, D.C.–based nonprofit started by public DB plan administrators and associated interest groups, has been vocal in perpetuating this myth.

# Debunking the Myth

- In a forthcoming paper for the Manhattan Institute, I investigated whether claims of DB cost-efficiency hold up to scrutiny and found that:

  - They are unsupported by the empirical evidence;

  - Are driven by false assumptions; and

  - Ignore pension debt as a significant cost driver for DB plans.

# Assume a Can Opener

- The DB plan efficiency straw-man is built on two erroneous assumptions:

    1. DB plans achieve better investment returns.

    2. DB plans offer lifetime income in the form of annuities, while DC plans do not.

- NIRS lists a third erroneous assumption (*i.e.*, consistent asset allocation), but it is only meaningful because the authors assume DC plans cannot offer annuities.

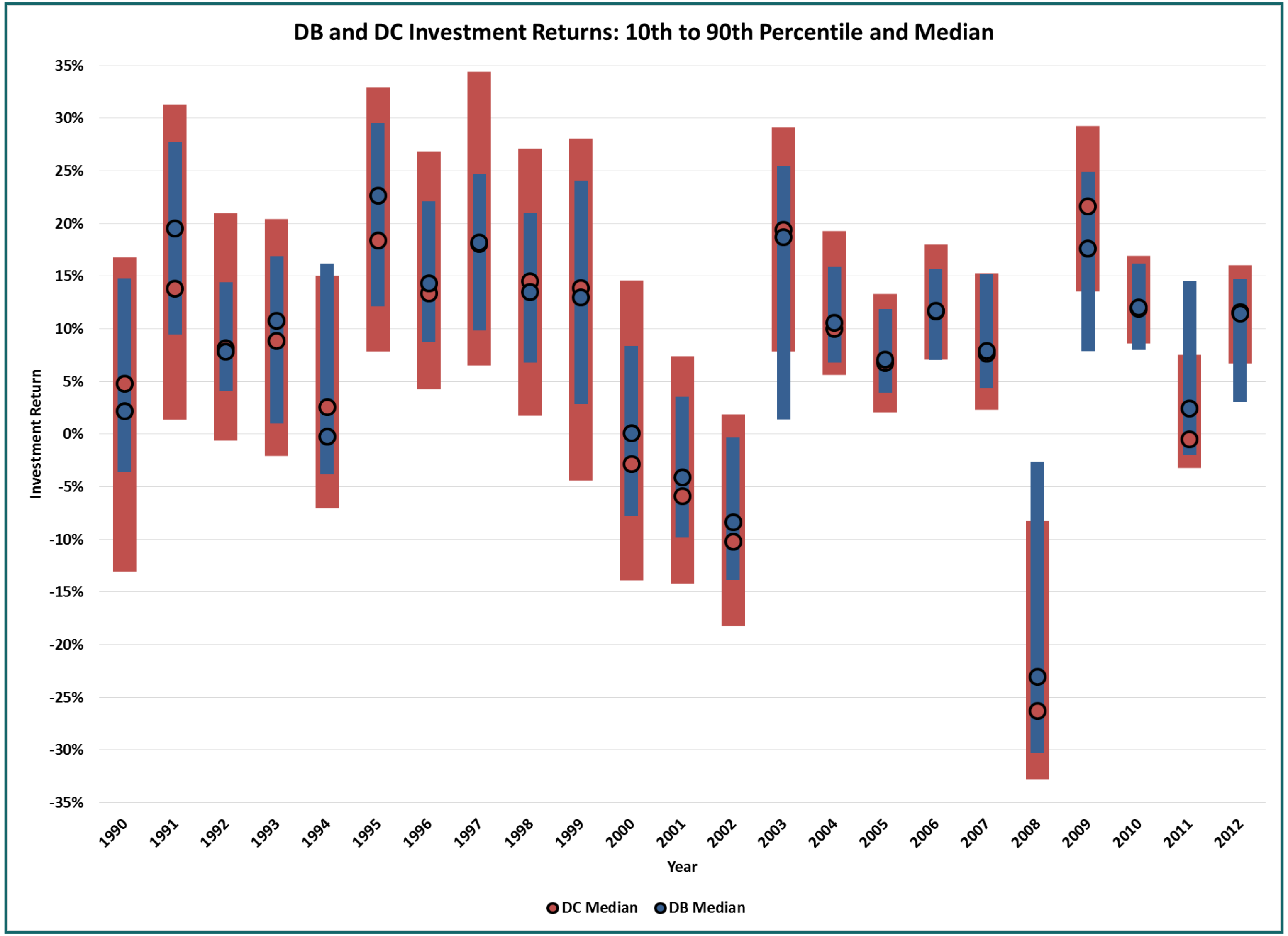
# Conflating Size and Plan Design

- Previous studies of investment returns from the Department of Labor (DOL), Towers Watson (TW), and the Boston College Center for Retirement Research (CRR) use metrics that conflate the effect of plan size and plan design.
- Private-sector DB plans’ assets are far more skewed toward big plans than are private-sector DC plans’ assets.
- While less than one-half of one percent of DB plans have $5 billion or more in assets, these plans represent on average 33 percent of DB plan assets.
- Plan weighted metrics provide a better measure of the investment performance by plan design.

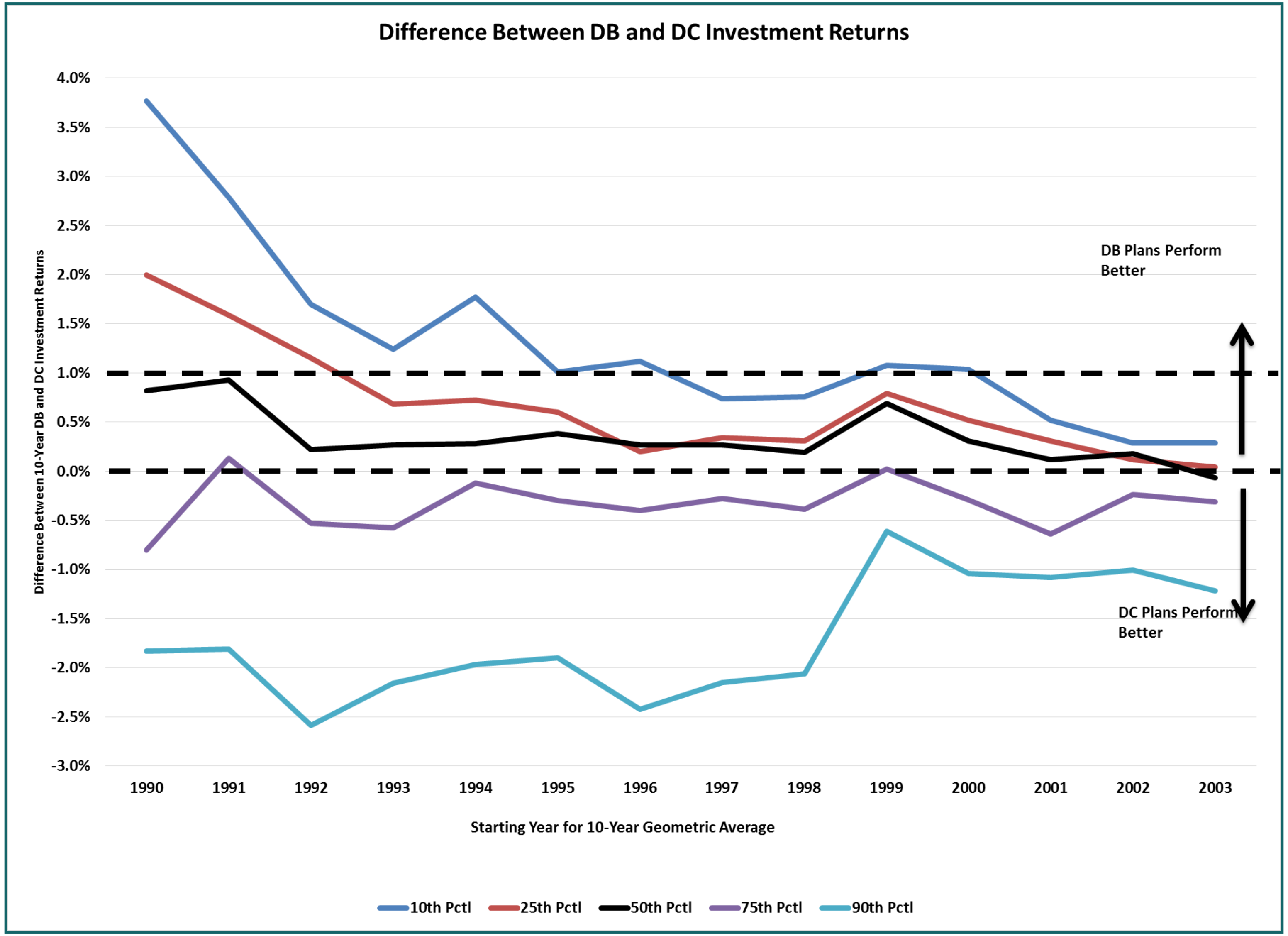
# Using the Better Measure, CRR and TW Estimates Show the Differences in Performance Are Quite Small

| | Years Included in Geometric Mean | DB Geometric Mean Return (%) | DC Geometric Mean Return (%) | Difference (percentage points) |
|---|---|---|---|---|
| 1988-2011 | 24 | 6.66 | 6.46 | 0.20 |
| 1989-2011 | 23 | 6.53 | 6.30 | 0.22 |
| 1990-2011 | 22 | 6.28 | 6.08 | 0.20 |
| 1991-2011 | 21 | 6.38 | 6.10 | 0.28 |
| 1992-2011 | 20 | 5.95 | 5.76 | 0.19 |

# There Is Significant Overlap in DB and DC Investment Performance



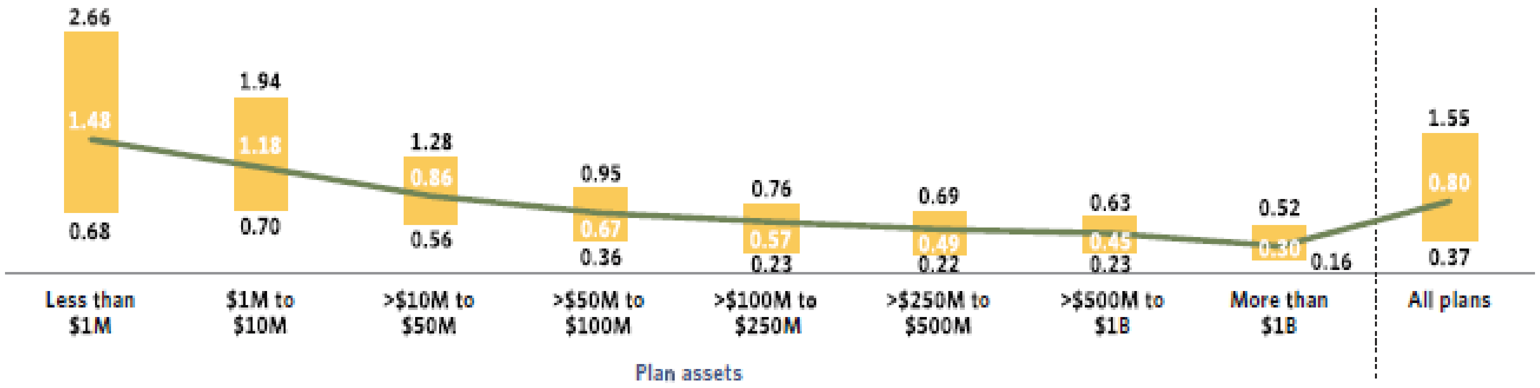
# Differences in Investment Performance Are Small and Not Statistically Meaningful



# NIRS and Others Dramatically Overstate DC Plan Fees and Understate DB Plan Fees

**Distribution of Total Plan Cost by Plan Assets**

*10th percentile, median, and 90th percentile plan-weighted total plan cost* as a percentage of assets among plans with audited 401(k) filings in the BrightScope database by plan assets (2012)*




* *Total plan cost* is BrightScope's measure of the total cost of operating the 401(k) plan and includes asset-based investment management fees, asset-based administrative and advice fees, and other fees (including insurance charges) from the Form 5500 and audited financial statements of ERISA-compliant 401(k) plans. Total plan cost is computed only for plans with sufficiently complete information.

Note: The sample is 14,020 plans with $2.5 trillion in assets. Audited DC/401(k) filings generally include plans with 100 or more participants. Plans with fewer than four investment options or more than 100 investment options are excluded from this analysis.

Sources: BrightScope Defined Contribution Plan Database and Lipper

Source: BrightScope and Investment Company Institute. (2014). "[The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans]."

# DC Plans Can and Do Offer Annuities

- While it is true that many private-sector DC plans do not offer annuities, this is not an inherent feature of DC plans.

- The limited availability of annuities in the private sector is largely the result of misguided federal regulation discouraging their provision. Nevertheless, a number of private-sector DC plans provide annuities.

- Most public-sector DC plans—which do not face these regulations—provide favorably priced annuities.

- Of the 25 public DC plans, 17 offer annuities through the retirement plan, with at least three states offering government-sponsored annuities (*e.g.*, Ohio, Washington, and Indiana).

# Claims That DB Plans Are More Cost-Effective Ignore the Steep Cost of Pension Debt

- For almost the entirety of their existence, public DB plans have been a creditor to state and local governments.

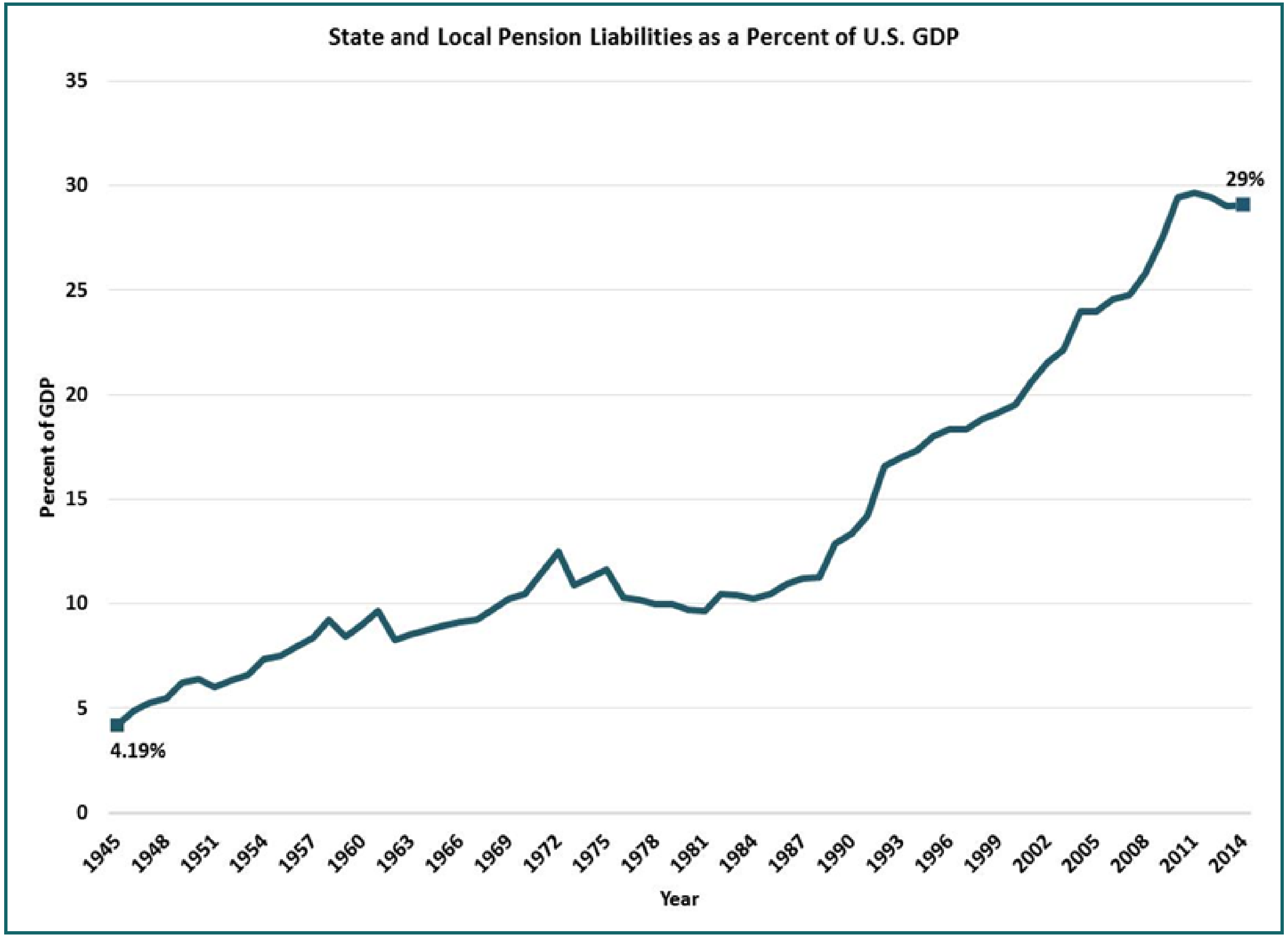
- Carrying pension debt—as with all debt—results in debt-service costs.

- Debt-service payments to pay off the accumulated pension debt are now larger than the annual cost of benefits earned by workers in most jurisdictions. (Debt-service payments in 2013 made up approximately 70 percent of annual required contributions.)

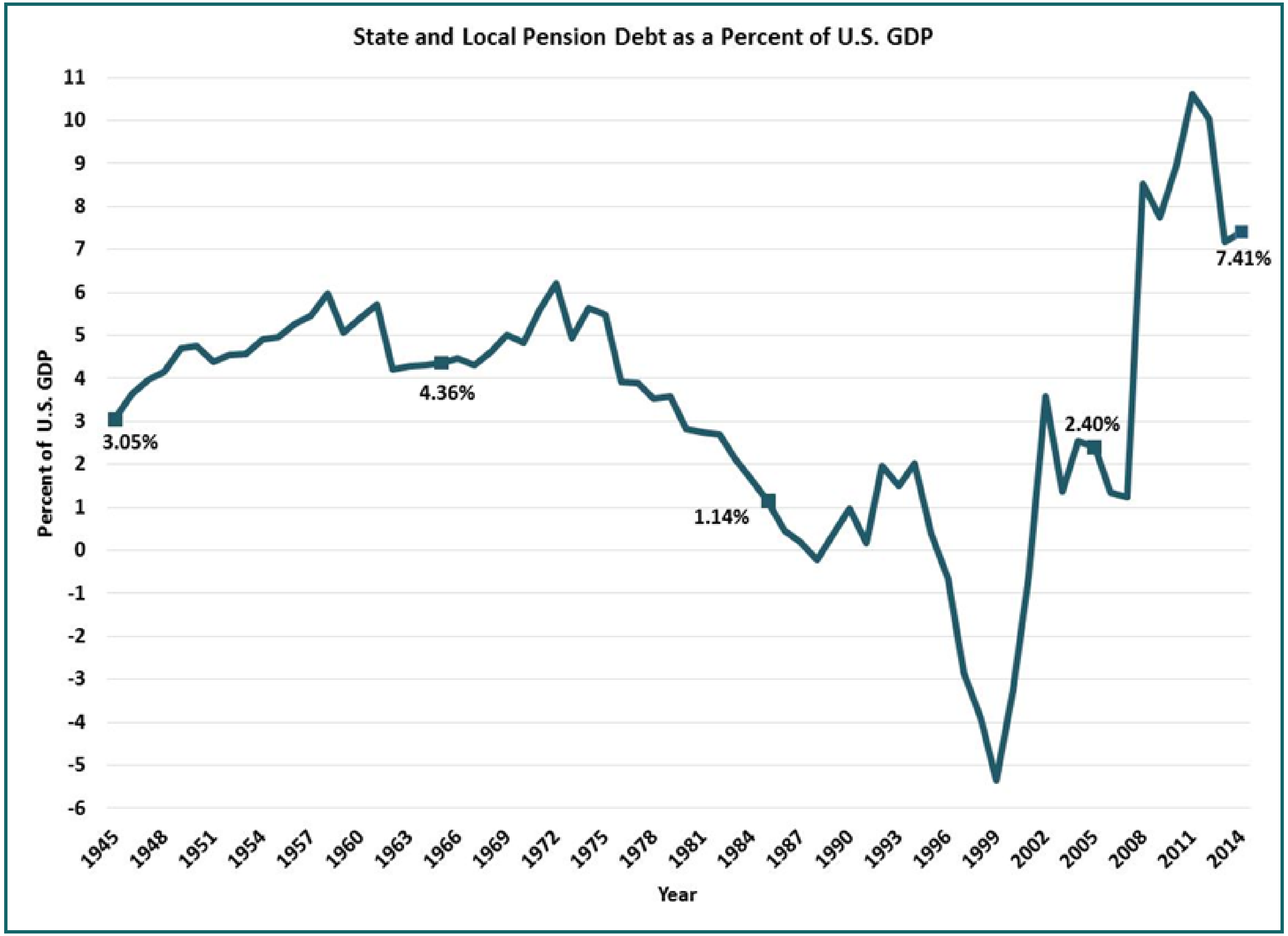
- Carrying a pension debt equal to 10 percent of liabilities would increase annual cost as a percentage of payroll by around 70 percent; carrying a debt equal to 20 percent of liabilities would increase cost by around 140 percent.

- The cost of carrying pension debt varies by plan, but in all cases, it is a relatively expensive proposition.

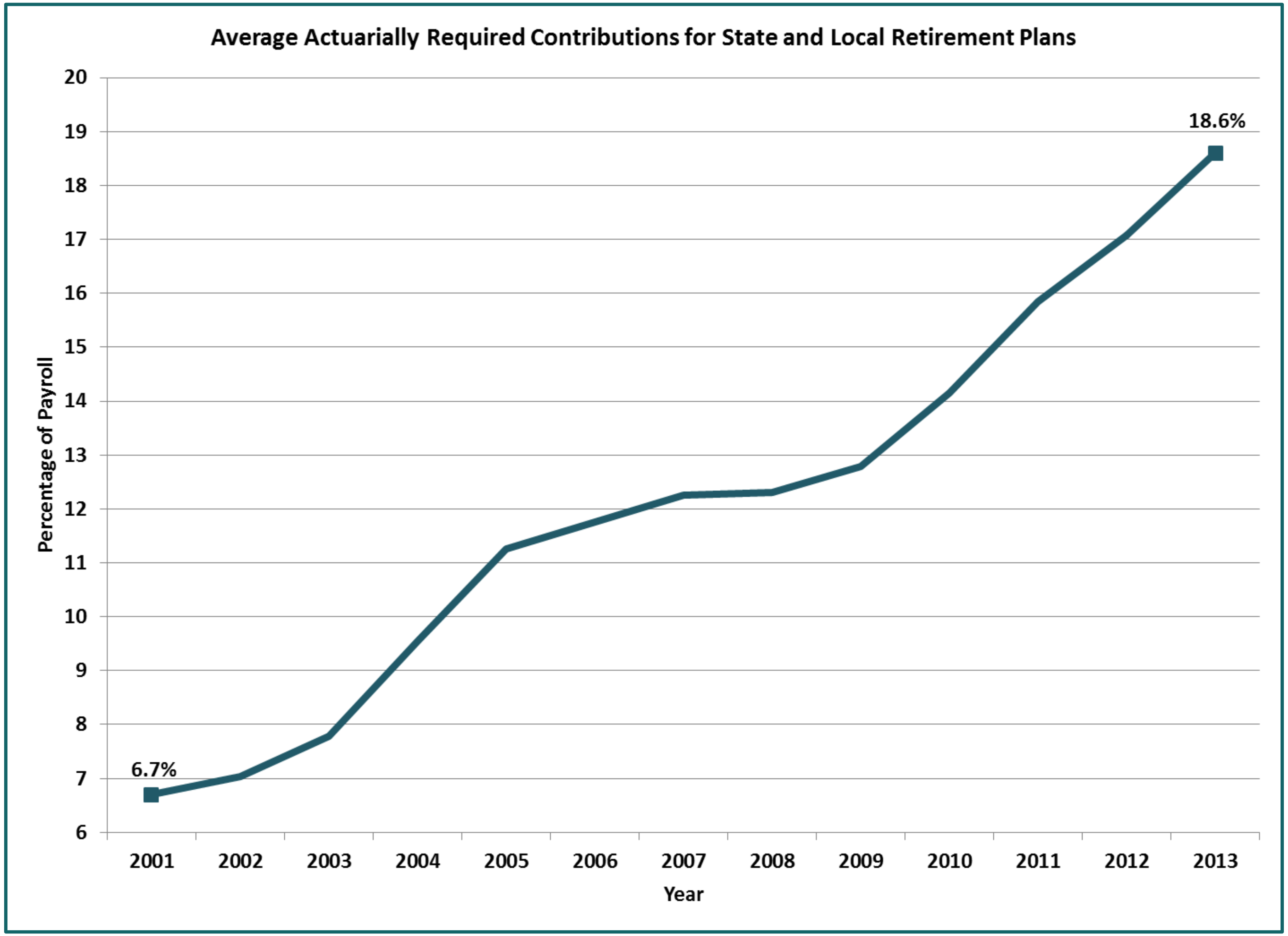
# Government Pension Promises Are Now 29 Percent of U.S. GDP



# Public Pension Debt Is Larger Than It Has Ever Been



# Retirement Contributions Have Nearly Tripled Since 2001



# DC Plans Are a Cost-Effective Way to Help All Workers Reach Retirement Security

- All primary retirement plans should incorporate adequate annual contribution/accrual rates; offer access only to pooled, professionally managed, and appropriately allocated investment options; and offer access to annuity options upon retirement.

- Primary retirement plans should have well-designed defaults so that if workers do nothing, they will still be placed on the path to a secure retirement.

- The DC plan design can incorporate all these features. In fact, many already do, especially those sponsored by public-sector employers.

# Additional Resources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