This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to colleagues, clients or customers, use the Reprints tool at the top of any article or visit: www.reutersreprints.com.

Why states shouldn't adopt defined-contribution pensions

March 1, 2011 @ 11:58 am

By Felix Salmon

Steven Greenhouse [1] has a long article in today's *NYT* about an attempt by the states to deal with their "strained" pension funds by moving to defined-contribution pension plans. Here's the lede:

> Lawmakers and governors in many states, faced with huge shortfalls in employee pension funds, are turning to a strategy that a lot of private companies adopted years ago: moving workers away from guaranteed pension plans and toward 401 (k)-type retirement savings plans.

What's a "huge shortfall"? Amazingly, nowhere in the 1,500-word article does Greenhouse actually say. Instead, we get incomprehensible tales like this:

> Utah decided to adopt a 401(k)-type plan after the stock market plunge in 2008 caused the shortfall in the state's pension plan to balloon to $6.5 billion…
>
> Under the new plan, [state senator Dan] Liljenquist said, the state's retirement contributions for new workers will be roughly half that for current employees, potentially saving $5 million a year for every 1,000 new workers hired.

So, the state of Utah has been putting insufficient money into its pension plan, and now there isn't enough money there to meet upcoming liabilities. And the solution here is for the state, in future, to contribute "roughly half" of what it's been spending up until now in pension contributions.

Needless to say, this makes no sense on either front. The liability to existing workers doesn't go away if a different plan is adopted for new workers, so the problems at the pension plan aren't being addressed. On top of that, it's hard to see how contributing much less to new workers' retirement is going to help them at all, either. From a pensions perspective, there's no winner at all: the only entity better off is the state, from a cashflow perspective.

On top of that, Greenhouse makes no attempt to put numbers like $6.5 billion or $5 million in any kind of context. Are they big? Who knows.

The only way I could make any sense at all of Greenhouse's article was to read it in parallel with Dean Baker's paper [2] on the origins and severity of the public pension crisis. The table he includes, which includes all state public pension funds, is invaluable; here, for instance, is Utah.

TABLE 2
Funding Levels and Liabilities for Major State Pension Funds

State	Plan	Actuarial Funding Ratio (percent)	Actuarial Value of Assets (thousand $)	Liabilities (thousand $)	Unfunded Accrued Liability (thousand $)	Unfunded Liability as a percent of Future State Income	Latest Actuarial Valuation Date
UT	Utah Noncontributory	85.6	16,622,548	19,429,734	2,807,186	0.09%	12/31/2009

What this shows is that the Utah pension fund, at the end of 2009, was about $2.8 billion in the hole. If it rose by 15% in 2010, which is a pretty reasonable assumption given the performance of the stock market, the gap is likely to have been all but eliminated. But even the gap at the end of 2009 was less than one tenth of one percent of Utah's state income.

All of these numbers are fuzzy, of course. Valuing assets is hard enough; coming up with a present value of future liabilities is much harder, and depends crucially on which discount rate you use. But Baker's numbers are pretty reasonable, and show that there really isn't anything to panic about here.

More generally, as Teresa Ghilarducci [3] notes elsewhere on the *NYT* website (but not in the paper), the idea that moving from defined-benefit to defined-contribution plans is going to help anybody at all is highly problematic.

> 401(k) plans are bad deal for taxpayers. Dollar for dollar, a traditional pension plan yields more pension benefits than do 401(k) plans because 401(k) management and investment fees are three times higher. And professionals who manage money in pooled pension funds usually get higher returns than workers who manage their own 401(k) accounts. The only clear winners when pensions switch over to the 401(k) plans are brokers and bankers…
>
> The unintended effect of widespread 401(k) plans is more volatility. In contrast to traditional pensions and Social Security, 401(k) plans fuel bubbles and make recessions worse. When the economy is booming, 401(k) plan asset values soar, making people spend more and work less. Not what you want in an expansion.
>
> Worse, when the economy plummets and takes 401(k) assets with it, people do the opposite; they cling to the labor market and rein in spending – again, two things you don't want in a recession.

On top of that, defined-benefit plans have a mutual-insurance component to them: shorter-lived workers subsidize longer-lived workers, helping to increase everybody's standard of living.

The fact is that the states' move to defined-contribution plans is a blatantly political one, born of Republican ideology conflating such plans with individual freedom and choice. For rich professionals who jump from job to job every few years, 401(k) plans do make a certain amount of sense. For public servants spending a lifetime in the police force or in elementary schools, by contrast, they emphatically don't. As for the state pension plans, the only way that the state governments can help them make up their actuarial liabilities is if they pour more money into them. Not less.

© Thomson Reuters 2011. All rights reserved. Users may download and print extracts of content from this website for their own personal and non-commercial use only. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is expressly prohibited without the prior written consent of Thomson Reuters. Thomson Reuters and its logo are registered trademarks or trademarks of the Thomson Reuters group of companies around the world.

Thomson Reuters journalists are subject to an Editorial Handbook which requires fair presentation and disclosure of relevant interests.

This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to colleagues, clients or customers, use the Reprints tool at the top of any article or visit: www.reutersreprints.com.