401(k)-Style Plan is not Better than Pension

Brent McKim Guest columnist

A host of inaccurate and misleading arguments were used in a recent column by Andrew Biggs to advocate for the governor's plan to close the existing Defined Benefit teacher pension system and place future teachers in a 401(k)-style Defined Contribution retirement plan.

The column incorrectly asserts that 401(k)-style retirement plans are less expensive than pensions. Evidence demonstrates, however, that pensions are far more efficient at delivering better retirement benefits at much lower cost to taxpayers than 401(k)style plans. There are several reasons for this.

A number of studies have found that, on average, the professional money managers that run Defined Benefit pension plans significantly outperform novice individual investors making investment decisions with their 401(k)-style accounts. And, because pensions include funds from thousands of plan members in one large pool, participating in a pension is like the investing equivalent of joining a wholesale club. The large volume of funds pension plans invest allows them to negotiate lower commissions and fees than individuals in 401(k)-style plans, who have to pay full retail price. These two factors combine to generate about a 27 percent cost savings for pensions over individual 401(k) plans. Including thousands of plan participants in Defined Benefit pensions also allows benefits to be paid out based on the average life expectancy of the entire group. If one person lives longer, another does not. Even if a 401(k)-style plan holder was able to match the investment return of a professionally managed pension plan, the 401(k) retiree would have to trickle out his or her retirement savings based on a life expectancy of 95 or 100, so as not to run out of money. This makes pension plans an additional 10 percent less expensive than 401(k)-style plans, for the same retirement benefit.

And, because pension plans constantly have new members entering them, they are ageless and can keep most of their funds in high-yield investments. When a 401(k) plan holder retires, he or she has to shift to more conservative, low-yield investments. This causes pension plans to be yet another 11 percent less expensive than 401(k)-style plans.

So if 401(k) plans are much more expensive for the same benefits, why have private sector companies shifted to them? There are a number of reasons, none of which apply to public sector employers.

First, and most importantly, 1990s Financial Accounting Standards tied corporate earnings to short-term pension swings, so a profitable business could look like it was losing money because a down market had reduced its pension assets. This, in turn, could interfere with raising investment capital for future corporate growth. There is no equivalent to this in public education. Second, rigid ERISA funding requirements make cash flow volatility more significant for corporations with pension plans than

401(k)-style plans. And, third, the sort of long-term employee retention that we value in school teachers and which is promoted by pensions, has come to be valued far less in the private sector. The 401(k)-style plans can be seen as a better fit for corporations with periodic employee layoffs. Finally, many mid to small sized companies simply do not have enough employees for pension plans to make sense. So the private sector shift to 401(k)-style plans is all about Wall Street, not because they plans are less expensive.

So those who believe in efficient government should reject more expensive 401(k)-style teacher retirement plans that waste taxpayer dollars costing far more for far lower benefits. This is illustrated by the objective financial analysis of the governor's proposed 401(k)-style plan by Cavanaugh-McDonald which found that switching teachers from a pension to a 401(k)-style plan would cost taxpayers $4.4 billion more in the first 20 years of the new plan, as compared to simply making the full payments for the more efficient pension currently in place.

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