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Public Employee Pensions – Making the Right Choice

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ABSTRACT

When it comes to public sector careers, one of the primary benefits of choosing a career of service is the opportunity to participate in a defined benefit pension plan. When properly funded and supported by local administrators, a defined benefit plan is the most beneficial option for all stakeholders involved. These stakeholders are the employees receiving the benefits, the administrators managing the plans, and, most importantly, the taxpayers who are providing the funding for these plans.

A defined benefit plan that is properly funded and administered ensures stakeholders involved are getting a pension system that gets more value out of every dollar contributed (Fornia & Rhee, 2014). When a public sector employee is deciding on the organization a strong fully funded defined benefit pension plan enables the organizations recruiting these potential job seekers an easier time in attaining the highest skilled workforce and then retaining them (Westerman & Sundali, 2005). The other main issue involved with defined benefit pension plans is the startup and administrative costs, which research has shown a defined benefit pension plan is cheaper (Gabriel, 2007).

Defined benefit plans are not without their detractors and one of the primary arguments related to this issue is a defined contribution plan enables the employees in the organization to have more control over their retirement accounts (Jankowski, 1997). With the ability to control retirement accounts in a defined contribution plan this also enables another level of control for employees by allowing an employee to move from organization to organization when they feel it is time to try a new organization.

This is not an easy subject and is going to take work from all the stakeholders involved. The problem of the public sector pension systems will not go away overnight, but with sound decision making and further education on making informed decisions, it can be remedied. The way to remedy this situation is for employers to retain their defined benefit pension plans and adequately fund and administer them.

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INTRODUCTION

The idea of being able to retire comfortably and as stress free from the struggles of financial burden is the dream of most Americans. The dream is no different for citizens in the private sector as it is for public service employees, all of which work towards living a self-sufficient and sustainable retirement. The focus of this discussion will be on the later of these two, public service employees being able to retire. Retirement for public employees, like private sector employees, should be attainable and something to look forward to. To reach this goal, public employees' retirement systems should not only retain defined benefit pension systems but they should also be adequately funded and supported by administrators.

A recent trend that is emerging across the country is to switch employees from defined benefit pension plans to defined contribution pension plans (Gabriel, 2007). The reasoning provided for the switch is generally the perceived cost associated with a defined benefit pension plan when, in reality, the cost is actually cheaper in a well maintained and regulated defined benefit pension plan. In light of the recent years, and with the financial instability of the financial institutions, local, state, and federal administrators are forcing this transition upon their employees. The issues surrounding this topic are complex and require serious debate and consideration to be resolved to accommodate all parties involved. An organization, whether local, state, or federal, has the need to recruit and retain the best possible employees to ensure the success of their mission. To ensure the best and most capable employees are recruited and retained, employers should offer defined benefit pension plans. The allure of a defined benefit pension plan offers employees more security when it comes to their retirement options. Another reason for offering or retaining a defined benefit pension plan is the financial savings offered to both the employee and the employer. The defined benefit pension plans, unlike the defined contribution pension plans that are individually managed, are managed as a group. The group effect of the defined benefit pension plans offers security to the employee and savings to the employer (Almeida, 2010).

Defined benefit pension plans are not without critics who advise switching to a defined contribution is the way to move forward. A switch from a defined benefit pension plan to a defined contribution plan allows the taxpayer to not bear the burden of funding a public pension plan. The costs associated with the savings at first glance would seem like a simple decision to make the switch but the problems associated with these switches is that the defined contribution plans are often underfunded. A defined benefit plan is also very well regimented and controlled by investment managers whereas a defined contribution plan is controlled by the individual employee. This control by the employee allows for choice when choosing where to invest one’s dollars and also the flexibility to transfer retirement plans from one job to another. The backside of this choice and flexibility for employees is the risk of investments not being chosen correctly by the employee who may not have a working knowledge of how to properly invest for retirement.

The right choice is not always the easiest choice, especially when this choice revolves around the retirement systems for public sector employees. A sustainable, cost effective, and efficiently managed pension system is what the employees and taxpayers deserve. The right choice to make these pension plans effective is that government agencies should retain and adequately fund defined pension plans for public service employees.

POSITION

The dynamic issues facing public service pension plans, while complex, is not an issue that is unresolvable. The issue does however require an examination into what the appropriate course of action should be taken. The first issue facing the current public service pensions systems is the financial obligations, or cost. While looking at this issue the current rational is to switch from a defined benefit pension plan to a defined contribution benefit plan to save monies. This approach is misguided and defined benefit pension plans work for taxpayers by squeezing more value out of each dollar contributed (Almeida, 2010).

The responsibility of governmental entities is to be fiscally responsible with the tax dollars they are entrusted with and by utilizing the defined benefit plans, these tax dollars are lumped together to better help handle the risks of financial markets. The costs to administer a defined benefit pension plan versus a defined contribution pension plan to a group of employees is estimated to be 46% cheaper (Almeida & Fornia, 2008). By pooling the resources together in a defined benefit pension plan, longevity risk pooling saves 15%, maintaining a balanced portfolio saves 5%, and superior investment returns save 26%. A more recent publication on the efficiency of defined benefit pension plans finds the defined benefit pension plans “can provide the same benefit at a cost that is 48 percent lower than the individually directed DC plan and 29 percent lower than the ideal DC plan” (Fornia & Rhee, 2014, p. 11). The article continues on to point out that to retire at $2,700 a month, a defined benefit pension plan requires only $500,000.

To achieve the same level of retirement income in an ideal defined contribution pension plan, the monies required are around $700,000 and in an individually directed defined contribution pension plan, the monies equal about $800,000.

The cost to manage and maintain a defined benefit pension plan versus a defined contribution pension plan indicate the participants will be provided retirement income at about half the cost if they utilize a defined benefit pension plan (Iacurci, 2014). The reasoning behind this substantial cost difference is broken apart in several different layers. The first layer to this is defined benefit pension plans have lower fees and are able to negotiate these fees, both administratively and investments, at a lower rate due to economics of scale. The defined benefit pension plans are also able to combine their longevity risk while maintaining an optimally balanced portfolio.

Due to the defined benefit pension plans being professionally managed, versus the individually managed defined contribution pension plans, the managers of these plans are able to manage the monies in the accounts with better returns than an individual. While the individual managing his own retirement fund is generally more apt to transition his retirement accounts into more conservative investments, a professionally managed defined benefit pension plan with multiple stakeholders is not bound by this same logic. The managers of the defined benefit pension plan, due to the continuous contributions of multiple employees, are able to keep pension funds allocated into more aggressive investments yielding higher end returns regardless of whether a few employees are nearing retirement. One of the few constants in any organization is that employees will retire and they will have to be replaced, generally with younger hires. The new hires begin to contribute right away to the group retirement fund creating an ever renewing stream of funding that replenishes the plan even as others draw from it.

Another issue facing public service careers is recruiting and retention issues due to pension benefits. The shrinking and shift of pension benefits from defined benefit pension plans to defined contribution pension plans is causing a direct issue with public sector recruiting and retention. When an employee goes into a public service career, they often enter what is often referred to as a psychological contract. The theory behind the psychological contract is that an employee enters into an agreement with an employer for three reasons. The reasons are outlined as an exchange of promises, mutually agreed on, and voluntarily made between two or more parties (Westerman & Sundali, 2005). The employee enters into a relationship with the employer and may feel betrayed by the employer when pension plans have been changed.

The changing landscape in defined benefit pension plans has some executives worried in law enforcement that the decline in benefits will cause officers to vacate the profession of law enforcement (Moore, 2011). These executives are concerned with the fact that law enforcement officers who are already working in a stressful and dangerous field will leave and it will pose significant issues to recruitment and retention abilities for departments. In a separate study, it was reported that switching from a defined benefit pension plan to a defined contribution pension plan would significantly hamper the public sector’s ability to compete with the private sector for qualified workers (Gabriel, 2007). The thought process behind this is the public sector employment traditionally has been unable to compete with private sector salaries but have traditionally been able to offer employees a secure retirement option in the defined benefit pension plans. To continue to recruit and retain these qualified applicants who could go into the private sector, it is important for retirement benefits to help attract these individuals. The report also details that with shifting demographics and an aging workforce, it is important to offer secure pension systems.

The startup costs and administrative fees for a defined contribution pension plan are substantially higher than a defined benefit pension plan. It has been reported “the operating expense ratio for a defined benefits plan averages 31 basis points (31 cents per $100 of assets); the average for defined contribution plans is three to six times higher at 96 to 175 basis points” (Gabriel, 2007, p. 4). These figures were accumulated by the Investment Management Institute. The defined benefit pension plan is reportedly cheaper to handle then a defined contribution pension plan.

COUNTER POSITION

The funding of public service pension systems can be a contentious topic in part due to the large number of stakeholders. The stakeholders are the employees who are going to receive the benefits, the employer who is going to provide the benefit, and the taxpayer who is going to fund the benefit. The large number of stakeholders listed who have a vested interest in the public service pension plans alone make this, at times, a very ‘hot topic’ issue.

The obstacles to funding these public service pension plans seems to center around whether the older system of defined benefit pension plans should be replaced by defined contribution pension plans. The proponents of a defined contribution pension plan will argue the freedom it offers to employees for choosing where their money is invested (Jankowski, 1997). While the employee has more control over their investments this also comes with more risk. The employee’s knowledge, discipline, and market performance would all play a key role in the investments an employee has made. The defined contribution pension plans offer employees the flexibility and freedom to pick which investments align with their beliefs in lieu of having a managed pension system make these decisions for them (Roberts & Hanley, 1997, p. 4). It also allows the employees, who are in control of their defined contribution plans, to take it with them to a future job opportunity enhancing their control of their retirement funds. The problem associated with this is that individual employees will not fully comprehend the financial market place and would require training programs on how to effectively manage and invest their funds. Defined contribution pension plans being controlled by the employee are often subject to the employee making poor financial decisions negatively impacting the returns (Iacurci, 2014).

The defined contribution plans also allow the employee the flexibility to transfer their funds when moving from job to another. This freedom can be enticing for an employee who finds a better opportunity and wishes to transfer the retirement funds they have already accumulated to their new employers account. This information was reported as “from an economic perspective, the features of a defined contribution plan are also desirable because they reduce obstacles to mobility in the labor market” (Roberts & Hanley, 1997, p. 4). A worker will fill more free to move around in the employment field to find the most lucrative position they can obtain. This is troubling for public sector careers though, who are already having a difficult time with recruiting and retention, due to the wages in the public sector can often be much higher in the private sector. If an employee in the public sector is a participant in a defined contribution pension plan, then leaving their field of expertise for a better paying private sector job would be an easier transition. While leaving the public sector service would benefit the individual employee, it would have negative ramifications on the employer in the costs to hire and train replacements. In a study of police staffing, as it relates to a segment of public service costs, it states “turnover can carry greater costs of turnover elsewhere because of the expense of selecting and training officers’ (Wilson, 2012, p. 334).

RECOMMENDATION

The complicated and emotional subject of funding retirement is not a subject to be taken lightly. The issue is multifaceted with proponents on each side of the fence; for this discussion, that fence is defined benefit pension plans versus defined contribution pension plans, calling for reform, and stating which route is the best route. The most feasible route is that public entities should retain their defined benefit pension plans, adequately fund them, and they should be supported by all parties involved. Whenever dealing with money, especially taxpayer’s money entrusted to the government to be spent responsibly, the issues and lines can be blurred and facts give way to emotion.

The reasons to retain defined benefit pension plans are numerous and straightforward. The main argument to keep them is they are more cost effective and save all parties money. The savings are substantial and in a time of decreased budgets and calls for government transparency, it makes sense for government institutions to stick with the most effective and cost efficient pension system. Another reason for government entities to retain a defined benefit pension plan is to recruit and retain the highest skilled employees possible. A corporation or private business would be unable to survive without competent and knowledgeable employees, so would a governmental agency. The research has shown it will be much more difficult moving forward for a government agency, that often times is unable to compete with the private sector in pay, because they will have an extremely difficult time with their staffing levels. As the population demographics continue to shift and older employee's transition from working to retirement, there will be jobs in need of being filled, both in the private sector and the public sector. A potential employee will be less apt to join the public service sector, even if it is their desire to serve in whatever capacity suits them, if the costs of doing so are so far below the private sector they know they will never be able to retire.

The proponents of change to a defined contribution pension plan cite several primary reasons to shift from the defined benefit pension plans. An employee who is part of a defined contribution pension plan has the freedom and ability to manage his own investments. The managing of these investments provide the employee an opportunity to align their investments with their beliefs. This comes with an inherit risk though of an employee, almost all of which are not trained in making financial investments, making poor financial decisions with their investments adding to the stress of the employee and risk of their investments (Butcher, 2014). The data also shows an employee will begin to move monies into more stable, less volatile, investments as they near retirement. While this does not seem like a bad choice on the surface, it actually deflates the funds in their pension accounts due to not getting the higher returns of riskier, more long term investments. If the employee were in a defined benefit pension plan, the monies are able to stay in these higher return investments to the pooling of monies and being managed by investment professionals.

The issue of pension funding does not appear it will be going away anytime soon, and the answers to this issue will not be easy. The employers cannot rely on the employee to take on all the burden of fixing the pension system while the employee cannot expect the employer to fix it on their own. The natural relationship between any employee, whether public sector or private, relies on a give/give relationship. The public administrations should be looking into ways to keep defined benefit pension plans intact and maximize their full potential. This should come in the form of consolidating pension systems from several different agencies to pool larger sums of financial resources together to make investing easier and more cost effective. Public administrators could also offer employees the options of starting a secondary retirement, like a defined contribution plan, as it was always meant to supplement, not replace, and is professionally managed so as to minimize the risks for the employee. The employee may also have to make concessions to help inflate and protect their defined benefit pension plans. The employee, with the public administrator’s approval and depending on the laws of their jurisdiction, can increase the amount contributed by them to help the funding levels. The employee can also make adjustments to the age at which they are able to collect funds from their pension systems, namely increasing the age to a reasonable level for all parties involved (Perkin, 2005).

The defined benefit pension plan is still the best route for public employees to be able to retire. This plan is also the best route for government agencies to be fiscally responsible with taxpayer money. The debate is far from over on the battle to switch public employees’ pension plans from defined benefit plans to defined contribution plans, but with all parties working together and adequately supporting and funding defined benefit pension plans, a positive outcome can be had for all.

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