An Elected Official’s Guide to DEFINED BENEFIT AND DEFINED CONTRIBUTION RETIREMENT PLANS

By Nicholas Greifer

Government Finance Officers Association
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FOREWORD

State and local financial managers are charged with operating retirement plans on behalf of millions of employees. On occasion, they must “take a step back” and examine how the retirement benefits are structured or designed. This guide serves as a tool in assisting elected officials in understanding the basic choices they have in designing retirement benefits.

My hope is that this guide serves as a user-friendly road map for elected officials and others that will enable them to make wise decisions regarding pension design. This is an important, fundamental and timely topic. Numerous factors are forcing elected officials to re-examine their pension systems, including: (1) the demographic changes of an aging workforce; (2) federal reform of Social Security; and (3) diminished expectations of lifetime employment. These forces all make questions about pension design—including questions about defined contribution and defined benefit retirement plans—important to understand.

The Government Finance Officers Association wishes to thank Nicholas Greifer, Senior Policy Analyst in the GFOA Research Center, for drafting this booklet. I would also like to thank the GFOA Chair and Vice-Chair of the GFOA Committee on Retirement and Benefits Administration who contributed valuable time to this guide: respectively, Patricia Wiegert, Retirement Administrator of the Contra Costa County Employees’ Retirement Association and Gary Anderson, Executive Director of the Texas Municipal Retirement System. Finally, GFOA is grateful to ICMA Retirement Corporation Executive Director Girard Miller and ICMA-RC Director of Retirement Plan Consulting Services Joe Jankowski as
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Introduction

Public employee retirement systems command a significant portion of the public purse. Collectively, local and state elected officials and their appointed administrators oversee about $1.6 trillion in retirement assets on behalf of nearly 14 million government workers and their families, as of 1997. For decades, state and local governments have managed retirement assets to fulfill several objectives, including (1) providing income security during retirement and (2) compensating workers for services rendered to the employer.

Over the past two decades, pension management professionals have experienced profound changes in how they go about meeting these objectives. Beginning in the private sector, regulatory and economic pressures have resulted in a shift from the traditional defined benefit (DB) pension to a different type of pension design, the defined contribution (DC) plan. Although most public retirement systems continue to use the DB approach to providing retirement income, many states and localities have examined the recent conversions to DC plans. In some cases, they have moved forward and established new retirement plans that incorporate features of the defined contribution model.

At the same time, state and local governments have experienced fiscal pressures such as the broad-based movement to institute limits on property taxes and other revenues. This has lent urgency to finance professionals and elected officials to search out new ways of delivering public services, including retirement benefits. Consequently, this publication aims to provide a practical introduction to an important, evolving area of public policy, thereby enabling elected officials to dispassionately assess both the defined contribution and defined benefit approach to providing retirement benefits.

An Elected Official’s Guide to Defined Benefit and Defined Contribution Retirement Plans is divided into seven sections. The first section introduces the concepts used by pension professionals, the second sets the recent historical context of
pension policy and the third is a detailed comparison of the two plan designs. The next two sections discuss internal administrative factors found in both DB and DC plans, such as portability provisions and budgeting. The following section evaluates external forces that elected officials may need to review when examining their local pension plans. The booklet concludes with a section on how to implement a DC plan.
What are the main types of retirement plans?

There are two basic types of retirement plans an employer can offer: a defined benefit plan and a defined contribution plan. Both plan types are subject to the same financial law or formula:

\[ C + I = B, \]

where \( C \) is contributions, \( I \) is investment income and \( B \) is benefits paid (net of expenses). In other words, what is put in \((C + I)\) yields the income for retirement \((B)\).

In the defined benefit plan, the target benefit \((B)\) is fixed, meaning that contributions \((C)\) must be adjusted up or down over time to meet that target. Governments using the defined contribution model fix contributions \((C)\) and consequently allow benefits \((B)\) to vary. They vary in accordance with fluctuating investment returns \((I)\).
How does a defined benefit (DB) plan work?

As the name implies, a defined benefit (DB) pension is income provided for retirement based on a formula that is fixed or defined. The size of the pension is fixed prior to retirement.

Usually, the formula is calculated as a percent of a worker’s salary earned shortly before retirement. The percent-of-salary figure typically increases with the number of years served. For example, the Arkansas Public Employees’ Retirement System sets a participant’s pension as follows:

\[
[\text{Final Average Salary}] \times [1.992 \text{ percent of salary}] \times [\text{number of years served}].
\]

Consequently, a person working for 10 years in the Arkansas system would obtain a pension equal to about 20 percent of the final salary, whereas an employee working for 30 years would get a better pension, covering about 60 percent of final salary.
How does a defined contribution (DC) plan work?

Under a defined contribution (DC) plan, a government and/or its employee contributes a fixed or defined amount of money to an individual employee’s retirement account each year. This contribution is fixed prior to retirement, based usually on a percentage of the worker’s current salary.

Once the money is in the employee’s account, the employee invests in various financial instruments. Typically, the employee chooses from a menu of options that has been designed by the employer.

At retirement, the employee obtains both the employer and employee contributions, and the earnings gained on the contributions. The actual dollar amounts are not known until retirement and are not guaranteed. Depending on the employer, the retirement income can either be obtained as a lump sum or as an annuity (i.e., divided into periodic distributions).
What are the common types of DC plans?

The table below lists the common types of DC plans in the private and public sectors. Since 1986, federal law has limited 401(k) plans to the private sector. The names for these plans are derived from the federal Internal Revenue Code.

<table>
<thead>
<tr>
<th>TYPES OF DC PLANS</th>
</tr>
</thead>
<tbody>
<tr>
<td>401 (k) plan – private sector</td>
</tr>
<tr>
<td>403 (b) tax-sheltered annuity – non-profit sector</td>
</tr>
<tr>
<td>401 (a) plan – government sector</td>
</tr>
<tr>
<td>Keogh plan – small businesses</td>
</tr>
<tr>
<td>457 Deferred Compensation – government sector (supplemental)</td>
</tr>
</tbody>
</table>
What are the key differences between DB and DC plans?

A DB plan offers a fixed income during retirement, whereas an DC plan provides a fixed contribution toward the employee’s retirement plan, as illustrated in the table below.

<table>
<thead>
<tr>
<th>FEATURE</th>
<th>DEFINED CONTRIBUTION</th>
<th>DEFINED BENEFIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Contribution</td>
<td>Fixed</td>
<td>Varies – depending on actuarial estimates</td>
</tr>
<tr>
<td>Retirement Income</td>
<td>Varies – depending on investment results</td>
<td>Fixed – by formula</td>
</tr>
</tbody>
</table>

This basic distinction implies several additional differences discussed in the remainder of this booklet. These include:

- Investment control;
- Budgetary predictability;
- Portability and
- Investment risk.
What are the similarities between DB and DC plans?

DB and DC plans have three similarities:

- They share the same objectives;
- They follow similar legal standards and
- They can be administered by the same organization.

Objectives. Both plans help accomplish two objectives:

- Compensating employees for services rendered and
- Providing adequate retirement income.

While each plan can help an individual meet these twin goals, they differ in the approach taken to meet them.

Legal Standards. Both plans are subject to similar legal and regulatory criteria. For example, the “prudent person” legal standard that applies to pension board members and other fiduciaries applies to both types of plans, although this standard is applied differently to each type of plan.

Administrative Entity. Both plans can be administered by the same entity. It is not necessary to set up a new pension system, for example, to manage a newly created defined contribution plan.
What are hybrid plans?

Hybrid plans take certain features of both defined contribution and defined benefit plans and combine them. For example, a government could set up a defined contribution component funded by employee contributions, and a defined benefit component financed by the employer. There is no one model for how to design a hybrid plan. Rather, it will vary from locality to locality.
What general fiduciary responsibilities apply to either a DB or DC plan?

Pension board directors and administrators are subject to many legal obligations derived from:

- Constitutional law;
- Statutes;
- Regulations;
- Contract law (e.g., collective bargaining agreements) and
- Common law.

The primary source of legal obligations for most public pension plan governing boards and administrators is state statutory law, according to a 1990 publication on pension plan legal obligations published by the Government Finance Officers Association (GFOA). State statutory laws often cover the entire range of duties performed by a pension system.

State law charges pension board directors and administrators with fiduciary duties, meaning that they must operate the pension plan in the interests of its beneficiaries. They must exercise due diligence in carrying out their tasks, subject to the “prudent person” legal standard. This standard means that a board member must act as a hypothetical prudent person would, if he/she were put in the same situation. This legal standard comes into play particularly when investing pension plan assets – the “area of greatest risk to plan participants, plan sponsors, or both, in the event of mismanagement, neglect, negligence, fraud, theft or embezzlement,” according to the GFOA publication referenced above.
The U.S. General Accounting Office reports that in all 50 states, state law stipulates fiduciary standards. Approximately half of the states follow the provisions of the Employee Retirement Income Security Act (ERISA) of 1974. While this federal law applies only to the private sector, these states have adopted provisions similar to ERISA.

For additional information, please refer to GFOA’s *The Legal Obligations of Public Pension Plan Governing Boards and Administrators* and consult with your government’s legal counsel.
What are the fiduciary responsibilities when operating a DC plan?

Retirement board members and administrators operating a DC plan are subject to the same prudent person standard as in a DB plan. However, the tasks that they carry out (such as employee education) are different, and so the application of the standard is different in a DC plan. For example, in a DC plan an area of legal concern is the accurate, timely payments to an employee’s retirement account.

Private employers must meet certain U.S. Department of Labor ERISA regulations, which, while not imposed on state and local entities, may influence their policies. These regulations insulate them from being liable for employee losses that occur when employees invest for themselves. Private employers allowing DC participants to manage their own investments must do the following:

- Offer a broad range of investment choices, including at least three diversified investment alternatives;
- Ensure that each of the alternatives have different risk/return characteristics;
- Provide descriptions of each of the alternatives (e.g., prospectuses); and
- Allow investments to be changed every three months or more often.

In addition, Labor Department regulation 404(a) holds plan administrators responsible for selecting and monitoring investments and service providers (e.g., through performance benchmarks).
As always, it is wise to review specific questions with your government’s legal staff.
Who qualifies for a DB or DC retirement benefit?

Qualifying for pension benefits is a function of:

• Employment status and

• Vesting schedules.

On the first point, generally a worker must be employed full time to be eligible for pension benefits. With certain exceptions, part time or seasonal workers cannot participate in either a DB or DC plan. In addition, ERISA allows private employers to restrict participation to workers over 21 years of age.

Vesting – the legal right to obtain pension benefits – varies from plan to plan. DB plans either provide gradual (“step”) vesting or complete (“cliff”) vesting after a waiting period. Since 1989, the federal government has required private-sector plans to fully vest participants after seven years of gradual increases or cliff-vest after five years.

In the public sector, most plans have five- or 10-year vesting periods. For example, the California Public Employee Retirement System vests employees after 10 years. Aggregate findings are shown in the table below. (The data are from the GFOA 1997 Survey of State and Local Government Employee Retirement Systems. The data do not indicate cliff or step vesting.)

<table>
<thead>
<tr>
<th>VESTING PERIOD</th>
<th>NUMBER OF PENSION PLANS</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 years</td>
<td>130</td>
</tr>
<tr>
<td>10 years</td>
<td>133</td>
</tr>
<tr>
<td>Other period</td>
<td>116</td>
</tr>
</tbody>
</table>

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What is the trend in the private sector in using DB/DC plans?

Private DC plans, 401(k) plans in particular, have grown rapidly. In five years, from 1983 to 1988, participants increased to 16 million from 3 million. The National Bureau of Economic Research reports that nearly all major employers were using 401(k) plans by 1990 (based on a survey of 900 major employers).

A 1996 U.S. General Accounting Office report also shows steady growth in DC-only plans among employers of all sizes during the 1984-93 period. As shown in the chart below, 88 percent of private employers used DC-only plans in 1993 versus 68 percent in 1984.

Not surprisingly, employees participate in 401(k) plans more often when their employers match their funding. According to the National Bureau of Economic Research, 75 percent of surveyed employees participated in the plans when their employer provided at least a nominal match. Ninety-nine percent of employees took part in the retirement plans when their company provided a dollar-for-dollar match (the most common level of employer matching found in the National Bureau of Economic Research survey).
What is the trend in the public sector in using DB/DC plans?

The federal government and some state and local governments have implemented DC plans in recent years. Additional state and local governments are considering doing so.

**Federal.** In 1987 the federal government converted from a DB plan to a new plan that has a core DC benefit known as the Thrift Savings Plan. This conversion has been gradual, with older employees remaining under the DB plan. New employees are automatically enrolled in the DC Thrift Savings Plan. As of Fiscal Year 1995, approximately half of the active federal participants are in this plan (1.4 million out of 2.8 million).

Like most DC plans, the Thrift Savings Plan contains the following features:

- Several investment options;
- Employee control over investment options;
- Joint contributions to the retirement by the employer and employee; and
- Enhanced portability.

**State and Local.** Many state and local governments have adopted DC plans recently. In certain states, such as Michigan, home-rule status gives cities the discretion to choose DC plans, whereas in other states enabling legislation is needed.

In Michigan, Oakland County and three other large pension systems have converted to DC plans. (Oakland County’s plan is described on page 52.) Similar DC plans have been devised for Montgomery County, Maryland; Littleton,
Colorado; and Auburn, Maine. In each of these four plans, employees become vested faster than under the old DB plan. The State of Kansas university system and the City of Wichita, Kansas have also adopted DC plans.

DC plans seem to be more common among state universities than among other state and local entities. University workers in over ten states have this option.

Although many states and localities have implemented DC plans in recent years, defined benefit systems are still much more common. Nationwide, 91 percent of state and local workers participated in DB plans, according to 1994 U.S. Labor Department data.
What explains the trend toward DC plans?

Why has there been movement toward DC plans? In the private sector, the U.S. Department of Labor’s *Trends in Pensions 1992* attributes the trend to three factors:

- Job growth by businesses that use DC plans (e.g., small businesses);
- Costlier regulation of private DB plans and
- Greater employee acceptance of DC plans, including union acceptance.

The Labor Department report states that: “Unions also appear to be much more willing to negotiate the establishment of DC plans. From 1977 to 1987, the proportion of unionized participants in DC plans increased from 15 to 37 percent.”

The U.S. General Accounting Office (GAO) credits DC growth to two additional factors:

- Businesses, through a DC conversion, capturing the assets of over-funded DB plans and
- Changes in worker preferences.

On the latter point, the GAO reports worker preferences have changed “based on their expectations of short tenures with several employers.”

In addition, changes to the federal tax code have facilitated the growth of private DC plans. For example, 401(k) plans were rarely used until federal laws and regulations were passed in 1978 and 1981 to facilitate their use, according to a National Bureau of Economic Research study.
Is the workforce becoming more mobile?

Increasingly, both public and private employers must recruit from a mobile labor pool. The average person works for seven employers over a 40-year career, reports the American Savings Education Council. New workers just entering the workforce will hold from seven to ten jobs over a career, according to the International City/County Management Association. Equally important, expectations of lifetime employment with one organization are declining, the Federal Reserve Bank of Chicago states.

U.S. Labor Department statistics corroborate the mobility trend. In 1991, the average time with one employer was 4.5 years. By 1996, this figure had declined to 3.8 years. Put differently, as of 1996, the average American worker will have nearly 11 jobs during a 40-year career.

As a result of mobility, relatively few public-sector employees become vested before leaving a retirement system. According to a 1994 GFOA report, most employees in public retirement systems quit or leave the system before becoming eligible. For example, plan participants in the Texas Municipal Retirement Service served an average 8.5 years, as of 1998, whereas they needed 10 years to vest. About one-third of the 93,000 participants are vested. Similarly, Institutional Investor reports that in 1995, of over one million public and educational employees in California, approximately one-third of those surveyed stayed in the system for the requisite 10 years in order to qualify for retirement benefits.
From the employee perspective, what are the pros and cons of a DB plan?

Defined benefit plans offer employees greater reward for long service to an employer and greater certainty of achieving a targeted level of income during retirement. On the other hand, defined contribution plans offer participating employees greater portability and investment control.

**Investment Control and Risk.** DB plan participants are shielded from investment risk, receiving a fixed retirement income. This means they are not subject to vagaries of the market. Furthermore, since retirement income is typically set at a percentage of final average salary and salaries tend to track inflation, DB participants are protected from inflation risk. On the other hand, by not having investment control, DB participants do not have the opportunity to participate directly in a bull market.

**Incentives for Longer Service Versus Portability.** DB plans reward loyal employees who stay with a particular government employer for a long duration. This is because the formula for determining retirement income is typically more generous the longer one stays with a particular employer. Which employees would find this an important incentive? This will clearly depend on individual preference as well as occupation, because certain public-sector careers such as firefighting are associated with longer tenure (see page 33).

In addition, employees who can retire at a relatively young age with full benefits may find a
DB plan attractive, in part because they would later be able to enjoy two sources of income: retirement income and wage income from a second job or career. Police and fire personnel are more likely to have such pensions.

As noted, DB participants do not have the same degree of portability. This is caused by typically slower vesting schedules so that a DB participant who is not vested would lose employer contributions when switching jobs. Secondly, participants who are vested often cannot roll over a lump-sum payment, obtaining a “deferred vested benefit” in its place. For example, a person changing jobs at age 40 after 10 years of credited service would get a pension with the employer, but it would be based on the final average salary calculated at age 40 – not at an age closer to retirement. In this scenario, the benefits would be frozen and not keep pace with inflation. While certain plans do index the deferred vested benefit to inflation, this is not the norm.
From the employee perspective, what are the pros and cons of a DC plan?

For employees, the advantages and disadvantages of a DC plan are essentially the opposite of those found in a DB plan.

**Investment Control and Risk.** DC participants have significantly greater control over their pensions because they can direct their investments. Usually they can choose from various types of investments. Consequently, DC participants are able to tailor their retirement investments according to their risk/return preferences. For cautious investors, many DC plans offer conservative portfolios (low risk/low return). On the other hand, more aggressive DC participants may prefer a less conservative portfolio (higher risk/higher return).

However, instead of receiving a pre-determined income at retirement, DC participants only obtain what their employer contributions, employee contributions and earnings on the contributions will yield over their career. This amount is not fixed but fluctuates.

Because employees have considerable investment control in DC plans, they necessarily face significant investment risk. The risk is simply that they will not make optimal selections, or not at the optimal time, to generate sufficient retirement income. Insufficient retirement income may be caused by either selecting investments that (a) are highly volatile or, conversely, (b) while not volatile, do not generate sufficient returns to outpace inflation. Plan administrators, however, can affect the degree of employee risk through employer education and the portfolio options made available to participants (see pages 37 and 55, respectively).
Portability. DC plans tend to be more portable for two reasons. First, employees tend to “vest” (i.e., obtain a legal right to their pension benefits) more quickly. Secondly, the retirement account can be “rolled over” to an Individual Retirement Account (IRA) or pension plan at a new job. In the public sector, DB portability is usually intra-state, often limited to pension systems that have reciprocity agreements.

The following table summarizes the respective strengths, as discussed above.

<table>
<thead>
<tr>
<th>ADVANTAGE TO EMPLOYEE</th>
<th>DEFINED CONTRIBUTION</th>
<th>DEFINED BENEFIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment control</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Investment risk</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Portability</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Incentive for Longer Service</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>
From the employer perspective, what are the pros and cons of a DB plan?

Employers experience certain advantages and disadvantages from using a DB type of pension plan.

Cost Predictability and Cost Transparency. In a DB plan, employers must set aside funding today to pay for retirement costs that will occur many years from now. Estimating those future costs and translating them into a retirement contribution made today is a complex process that is not “transparent.”

In addition, states and localities operating DB plans do not enjoy the same degree of budgetary predictability as in a DC arrangement. Put differently, the yearly fluctuation in funding a DB plan can be large, due to actuarial uncertainties about:

- Future rates of returns on pension fund investments;
- The demographics of the workforce;
- Employee turnover;
- Future salary decisions and
- Policy decisions often imposed upon the pension system by a state legislature (i.e., unfunded mandates).

Investment Risk. In a DB system, employers are exposed to investment risk. Consequently, employers must make additional contributions when investments do not meet targeted rates of return. Conversely, when investment earnings exceed projections, this may offer the employer an opportunity to make smaller contributions.
Recruitment, Retention and Downsizing.

DB plans are effective in shaping the composition of the workforce in three ways. First, DB plans help in retaining employees for a long tenure because:

- Vesting schedules are relatively slow and
- According to the U.S. General Accounting Office, accrual of benefits escalates at the end of one's career with a particular employer.

Consequently, there are significant monetary incentives to stay at a job that offers a DB plan.

Second, DB plans can be used to accelerate departures from an employer through early retirement. By using one-time “sweeteners” to the retirement formula, employers can replace older, highly paid workers with newer, less expensive workers or simply reduce the workforce.

Third, DB plans may assist in recruiting certain categories of workers (while being less attractive to others). For instance, workers who have high expectations of working with the same employer over his/her career may prefer a DB plan. In addition, workers who expect to stay in the same field (e.g., policing) and in the same state may find a DB plan attractive, if that plan’s service credits can be transferred to another in-state police force. Conversely, more mobile workers may prefer a DC plan.

Comparing DB and DC Costs. As noted on page 43, the body of knowledge on DB/DC costs is limited in the public sector. Consequently, there is no easy answer to the question: “Which type of pension is less expensive for my government to administer?”

Two observations can be made, however. First, the International City/County Management Association reported in 1996 that DB plans have higher operating expenses for activities such as actuarial evaluations and investment management. On the other hand, they may have lower costs for employee education. Second, since most local governments and states already have DB plans in place, they would not encounter start-
up costs or conversion costs if they stay with a DB arrangement. In contrast, instituting a new DC plan usually means setting up and operating two plans for a period of time.
From the employer perspective, what are the pros and cons of a DC plan?

Employers enjoy several benefits and face several drawbacks from adopting a DC retirement plan.

**Cost Predictability.** From an employer perspective, perhaps the most important benefit of DC plans is predictable budgeting. This predictability stems from the yearly requirement that a municipality simply pay a pre-determined amount to an employee’s retirement account, tied to a percentage of an employee’s salary. This amount is easy to predict with accuracy and tends to increase at a fairly steady rate, in line with inflation. In contrast, the cost of DB pensions fluctuates annually.

**Cost Transparency.** In a DC plan, costs are transparent and easily understood: each year an employer is liable and must pay for a certain contribution to an employee’s retirement account. In contrast, the cost of a DB plan is difficult to understand for two reasons:

- The cost is for an event or obligation – retirement – that does not take place for many years; and

- Actuarial calculations necessary to estimate the cost of this obligation are based on many fluctuating variables. These variables include the demographics of the workforce and rate of return on investments, among others.

**Investment Risk.** A basic difference between the two plans is that DC plans shift investment risk from the employer to the employee. Employers benefit since they do not have to make additional retirement contributions should the financial markets yield low investment returns.
Recruitment and Retention. Employers can use DC plans as a method to attract new employees who place a premium on portable pensions. Persons who may value portability are mobile workers who:

- Must exit the job market occasionally (e.g., primary caregivers in a family);
- Face job insecurity (e.g., city managers subject to dismissal) or
- Have diminished expectations of job security (e.g., workers vulnerable to outsourcing).

DC plans are not as effective as a tool for retaining employees over a long time period. In a DB plan retirement benefits accrue slowly, toward the end of one’s career. In contrast, DC plan benefits do not accrue slowly and the employer cannot “back-load” retirement benefits as a long-term retention tool.

Cost Savings Uncertain. The number of examples of conversions from DB to DC plans, while growing, is still limited. Consequently, although a few governments such as Oakland County, Michigan, report cost savings because of a conversion, the evidence to date is uncertain. Please turn to page 43 for an expanded discussion of this issue.

The following table summarizes the benefits and drawbacks of each plan, as discussed on the preceding pages.
<table>
<thead>
<tr>
<th>ADVANTAGE TO EMPLOYER</th>
<th>DEFINED CONTRIBUTION</th>
<th>DEFINED BENEFIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost Predictability</td>
<td>X</td>
<td></td>
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<tr>
<td>Cost Transparency</td>
<td>X</td>
<td></td>
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<tr>
<td>Investment Risk</td>
<td>X</td>
<td></td>
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<tr>
<td>Recruitment Tool</td>
<td>X</td>
<td></td>
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<tr>
<td>Retention Tool</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Downsizing Tool</td>
<td>X</td>
<td></td>
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<tr>
<td>Start-Up Costs</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Overall Cost Savings</td>
<td>Indeterminate</td>
<td></td>
</tr>
</tbody>
</table>
INTERNAL
ADMINISTRATIVE
FACTORS TO
CONSIDER IN
SELECTING A PLAN
DESIGN

What is the difference in portability?

DC plans are more portable because of faster vesting and easier ability to transfer assets or benefits. For example, the Los Angeles Water & Power Employees Retirement Plan has a five-year vesting schedule for its DB beneficiaries and only a one-year schedule for the DC enrollees. Oakland County, Michigan, Montgomery County, Maryland, Littleton, Colorado and Auburn, Maine all have faster vesting for their DC enrollees than their DB counterparts.

In the private sector, the U.S. Department of Labor reports that “Immediate vesting is virtually non-existent in defined benefit plans,” but 37 percent of profit-sharing plans and 30 percent of savings and thrift plans [two common types of DC plans] in medium and large firms offered immediate vesting in 1989. The U.S. General Accounting Office reports that the Tax Reform Act of 1986, which shortened vesting periods, will result in greater benefits for short-term workers.

When a vested DC participant leaves a unit of government, his account can also be “rolled over” to an Individual Retirement Account (IRA). Roll-overs are an important benefit, since the money moved to an IRA likely will continue to grow in value.

In contrast, a vested DB participant often cannot obtain a lump-sum payment which could be rolled over to his/her IRA account. Instead, DB
benefits remain with the employer. In this situation, the benefits may be frozen at the time the person leaves the job, thus not keeping pace with inflation. For example, a 40-year-old employee who leaves a job and who retires at age 65 would have a retirement benefit frozen for 25 years. However, in some states, reciprocity agreements between governments allow certain DB participants to transfer their pension between those governments when they change jobs – thus allowing the pension to grow in value.
Which employees would benefit from portability?

An important factor in evaluating DB and DC plans is the mobility of the workforce, as well as the labor market from which future workers are recruited. The average worker – public or private – stays with an employer for only 3.8 years, according to 1996 U.S. Labor Department data. In the public sector, the International City/County Management Association reports that the average worker stays with an employer for 9.3 years.

Furthermore, only 17.8 percent of public- and private-sector workers were with an employer for 10 or more years, according to the Labor Department. Since this is often before an employee vests, a majority of workers would be likely to benefit from expanded portability.

Certain workers stand to gain more from enhanced portability than others. In general, these are workers who:

- Have less perceived or real job security, such as top-level managers and workers in departments that can be privatized or
- Exit the job market for other reasons (e.g., primary caregivers).

Labor Department data from 1996 show that of the occupations with the 35 longest occupational tenures – i.e., greatest stability – five are in the public sector. (Presumably other public-sector occupations have shorter tenure or less stability.) Even among these five career paths, there is considerable variation, as shown in the table.
<table>
<thead>
<tr>
<th>CURRENT OCCUPATION</th>
<th>TIME WITH EMPLOYER</th>
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<tr>
<td>Fire-fighting Supervisor</td>
<td>20.3 years</td>
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<tr>
<td>Policing Supervisor</td>
<td>15.1</td>
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<td>Teacher, Secondary Education</td>
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</tr>
<tr>
<td>Public Transportation Attendant</td>
<td>8.2</td>
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</table>
What are the types of risk unique to each type of plan?

In a DB plan, the retirement plan sponsor assumes the investment risk. Pension managers must invest yearly contributions in the financial markets. Should the investments fall short of expectations, the employer must make up the difference.

In many states, governments cannot reduce a benefit once it is promised. In fact, many states guarantee in state statute or in state constitutional law that the retirement benefit to existing participants will not be diminished.

A DC plan shifts significant investment risk to the employee. Consequently, employees must manage the risks that their investments:

- May not provide sufficient returns at retirement due to volatile returns and
- May not keep pace with inflation due to excessively conservative investments.

In contrast, DB retirement benefits tend to keep pace with inflation, since the benefit formula is based on final average salary – which presumably tracks the rate of inflation.

In either plan, employees face an additional risk: failing to preserve their retirement benefits. A 1989 GFOA study showed that a hypothetical worker who switches jobs frequently (five times in a 42-year career) could better manage the “preservation risk” by following a strategy of working only for employers offering portable DC benefits. Conversely, a person who works only for DB employers faces a downside risk if they switch jobs. This risk is significant, as a 1994 GFOA report indicates that most employees in
public systems fail to capture retirement benefits before leaving a job.

An additional preservation risk is that employees who gain access to their retirement accounts – either through loans taken from their retirement account or through lump-sum distributions when changing jobs – will not return the dollars to a retirement account.

Legal risks are discussed on pages 10-13.
What are strategies for managing DB risk?

With regard to investment risk, plan administrators can take, at minimum, the four steps listed below:

• Establishing an investment policy;
• Adhering to the policy;
• Developing an asset allocation plan that diversifies the risk of investing in one security and in one asset class; and
• Monitoring asset allocation targets and other performance benchmarks.

For instance, the Virginia General Assembly’s assessment of the Virginia Retirement System examined investment policy, asset allocation and investment performance, as well as the pension board’s oversight of the system.

Additional information about risk management is discussed in the February 1995 issue of the Government Finance Officers Association’s Government Finance Review, which explains the role of modern portfolio theory in establishing a sound asset allocation plan.
What are strategies for managing DC risk?

Employees who are subject to investment risk in a DC plan can take similar steps to manage risk. Of course, because individual employees have different risk/return preferences, they will make markedly different investment decisions.

Employees can take the following actions in managing risk:

- Establishing retirement goals;
- Doing a self-assessment of risk tolerance;
- Defining a time period for retirement investments;
- Establishing an asset allocation plan that diversifies the risk of investing in one security and in one asset class; and
- Monitoring asset allocation targets and other performance benchmarks.

What role can the employer play in helping DC participants manage risk? Employers can help their workers manage risk through education – e.g., brochures, self-assessment guides and/or educational seminars. Furthermore, they can structure investment options to preclude certain investments. For example, as of 1995 the federal government offered its employees three options: federal fixed-income securities, a commercial bond fund and a stock fund. (Since then, legislation has been introduced to allow the federal retirement system to offer a small capitalization stock fund and an international stock fund.)

Finally, employers can help their staff manage risk by offering certain retirement payout choices. For instance, through DC plans workers
could have the option of a retirement annuity. By doing so, risk is shifted to the private vendor offering the annuity.
Are there differences in ancillary benefits?

In addition to income security, retirement plans offer ancillary benefits. For example, almost all public retirement systems offer disability benefits in the event that a public employee is no longer capable of working, or performing the same type of work (e.g., policing), as before an injury occurred. In the limited cases where DC plans are in effect, most offer similar disability benefits. For example, the ICMA Retirement Corporation reports that nearly all employers it serves which have converted to a DC plan offer disability coverage either through self-insurance or a commercial plan.

DB plans offer survivor benefits. For instance, a common formula is to provide a widow or widower 50 percent of the retirement benefit if the employee dies. In contrast, a DC participant can designate benefits to a spouse or any other person in the event of death.
BUDGETING FOR DEFINED BENEFIT/DEFINED CONTRIBUTION PLANS

What are the employer’s financial liabilities for DB plans?

DB plan sponsors are liable for the cost of both old pension commitments made in prior years and new pension commitments incurred each year. The cost of any outstanding pension obligations made by the employer in past years is the unfunded actuarial accrued liability. This cost, expressed in today’s dollars, is often spread over future years.

New obligations are added to the old. The new obligations, the “normal” cost, are expected to be paid in the current year. Thus, hiring new workers adds a new cost to the pension system and this incremental cost is paid for in the year that it occurs or is recognized. (Note that pension administrators have the discretion to use different funding methods. Using one funding method will yield different contribution requirements than another.)

DB liabilities can vary significantly from year to year. A GFOA analysis of 31 single-employer plans shows the budgetary impact on an employer:

- Of the plans analyzed, 21 of 31 have up-and-down funding patterns (similar to those of the Arlington County, Virginia Employees’ Retirement System as illustrated on the graph on

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1GFOA staff examined 31 single-employer systems with assets under $2 billion to gauge the impact from an employer perspective. The funding patterns are based on actuarially required contributions as reported in the comprehensive annual financial reports provided by the 31 systems.

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characterized by alternating increases or decreases in yearly funding needs rather than steady growth; and

- Twenty-four of the 31 plans exhibit large deviations from inflation. These are pension systems that have had pension funding changes that are 10 percent above or below the inflation rate.

For elected officials, this budgetary uncertainty is important when they have to weigh pension funding priorities against other programs of the government.
What are the employer’s financial liabilities for DC plans?

DC plans are liable for the costs of the periodic payments to workers’ retirement accounts. Typically, the contribution is made on the payroll cycle. Consequently, elected officials cannot build unfunded liabilities as they may in a DB arrangement.
Is one type of pension plan inherently less costly?

There is no inherent reason for either a DB plan or a DC plan to cost more (i.e., require more contributions from the employer). Put differently, a government that compares a hypothetical DB plan and a hypothetical DC plan by “plugging in” the same assumptions to both plans can yield identical cost estimates. Both plans are subject to the same mathematical formula:

Contributions + Investment Income = Retirement Benefits.

In the real world, however, there probably will be differences in cost between the two plan designs. For example, there may be differences in administrative costs, discussed on the next page. However, in the public sector there is an extremely limited body of evidence to allow for an “apples-to-apples” comparison of the two methods in the public sector. Private-sector DB plans have faced unique ERISA costs that have pushed them in the direction of DC plans, but public employers are exempt from ERISA.

The Government Finance Officers Association’s 1997 Survey of State and Local Government Employee Retirement Systems obtained data from 13 DC plans. Their costs varied considerably. The City of Grand Junction, Colorado DC plan required a 6 percent (of payroll) employer contribution at one extreme, whereas the Central Florida Regional Transportation Authority DC plan had a 12 percent employer contribution. (Figures do not include hybrid plans.)
What administrative costs are involved in the two plans?

The costs of administering either a DB or DC plan include the following:

• Custodial services;
• Recordkeeping;
• Investment management and
• Employee education.

Although both plans incur costs for recordkeeping and employee education, DC plan costs may be greater in this regard. (Given that employees manage their own retirement accounts in a DC arrangement, greater employee education is probably necessary.) On the other hand, only DB plans require actuarial services.

In the private sector, the average reported administrative expense per plan participant was $103 in DC plans and $157 in DB plans in 1993, as reported by the U.S. General Accounting Office (GAO). These cost differences have remained approximately the same from 1988 to 1993. The GAO report did not explain why the costs differ (e.g., whether this was due to ERISA).

Who pays these costs? In a DB plan, the employer usually incurs the management costs. In a DC arrangement, employees share a greater portion of the management costs. For example, employees in a DC plan are apt to pay for investment management services via a percentage deduction from their retirement account.
How predictable are retirement costs?

DC plans are more predictable because the government is not budgeting dollars for an event (retirement) that will occur years or decades from now, but rather to pay for a yearly contribution. Furthermore, DC plan contributions are fixed at a percentage of salary. In contrast, DB plans are based on many uncertain factors such as workforce demographics, mortality, return on investments and inflation.

As a result, from an employer perspective, DB plans have funding patterns that move up and down over time. For example, the Arlington County, Virginia Employees’ Retirement System has experienced large funding swings from 1992 to 1997. Single-employer plans like Arlington County’s may vary more than large, multi-employer plans.

![Example of Funding Fluctuation](image)

Please note that the graph reflects the actuarially required contribution (i.e., what should have been appropriated).
EXTERNAL FACTORS TO CONSIDER IN SELECTING A PLAN DESIGN

What is the government’s financial environment like?

The budgetary environment within which it operates will likely affect a government’s interest in DB and DC plans. For example, the County of Oakland, Michigan, viewed a DC conversion as a partial response to a state-imposed constitutional limit on revenues.

State and local tax and expenditure limits are widespread, according to data from the U.S. General Accounting Office summarized below:

- **States** – 21 have spending limits, seven have revenue limits and three have both;

- **Counties** – 49 of 66 larger counties surveyed by the National Association of Counties have property tax limits and

- **Cities** – 51 percent of cities responding to a U.S. Conference of Mayors survey report being at their legal limit for property tax rates.

In Illinois, for example, non-home rule counties, municipalities, schools and special districts can only increase their property tax revenues at the rate of inflation or 5 percent, whichever is less. In this fiscal environment, budgetary control and predictability become more important in evaluating DB and DC plans.
How does Social Security affect pension plan design?

The decision to offer employees a DB or DC alternative may be affected by the other retirement benefits they already have. Retirement income has often been compared to a three-legged stool consisting of:

- Social Security;
- An employer retirement plan and
- Personal savings.

A state or local government considering changes to the retirement plan can examine each of these components as a whole. In this way, the decision to shift investment risk to an employee – by the creation of a DC plan – could be viewed as being offset by the guaranteed income of Social Security. (This assumes that a government employer offers Social Security, when in fact many do not.) Conversely, legislation that would end Social Security as a purely defined benefit plan might affect a decision to institute a DC plan.
Does the IRS tax each plan differently?

No. As long as both are IRS-qualified plans, the retirement income grows tax-free. The IRS considers as qualified plans that they deem to be in compliance with section 401(a) of the Internal Revenue Code. Among other provisions, the code limits annual contributions on behalf of employees.

By being IRS-qualified, taxes that would apply to investment earnings are deferred until retirement – regardless of whether that is a lump-sum distribution (as often found in DC plans) or annuities (as often found in DB plans).
IMPLEMENTATION CONSIDERATIONS

What are the methods of converting to a DC plan?

States and localities that convert to DC plans have three options:

• Immediate conversion;
• Gradual conversion and
• New-employee-only conversion.

Each of the approaches affects certain employees differently. Government employers’ discretion in choosing among these three options may be limited by state law (e.g., laws requiring no reduction in benefits to certain employees).

The immediate conversion approach actually terminates a DB plan for all working employees (retirees are unaffected). Current employees who had been under the old DB plan must be transferred to the new DC plan. This may benefit most employees; however, certain long-term employees may be better off under the old plan.

The gradual conversion approach enrolls both new employees and existing employees who volunteer for the DC plan. Existing employees retain the right to stay with the old DB plan. Depending on the terms of the conversion, a municipality may expend additional dollars to convert existing staff to the new plan if they are given financial inducements to switch.

The new-employee-only approach gives DC benefits only to newly hired personnel. Existing employees do not have the DC option. Like the gradual conversion approach, this approach would require the municipality to operate both a DC and DB plan during a transition period.
Through attrition, all employees would eventually be in the DC plan.
What are examples of conversions from a DB to a DC plan?

In the December 1998 issue of the Government Finance Officers Association’s *Government Finance Review*, seven systems’ experiences in converting to a DC plan are discussed. The systems are Oakland County, Michigan; Wayne County, Michigan; State of Michigan; Washington State Teachers Retirement System; Webster Groves, Missouri; Orlando, Florida; and Fort Smith, Arkansas. Some of the common features were the following:

- In most cases, the plan was optional for existing employees and mandatory for new hires;
- Existing employees making the switch had the value of the retirement benefit (measured in present value terms) transferred to their new DC account; and
- Vesting was relatively fast, seven years or less.

The table on the next page summarizes the Oakland County, Michigan experience.
CASE STUDY: MICHIGAN COUNTY MAKES A GRADUAL CONVERSION TO DC PLAN

Where: Oakland County, Michigan.


Who: All new employees hired after July 1994 as well as current employees who opted to switch to the DC plan by January 1996. Over 40 percent of eligible employees voluntarily switched to the new DC plan. Thirteen of 14 bargaining units elected to get into the DC plan after non-union employees elected to do so.

How: To promote joining the DC plan, current employees received a financial inducement and intensive education about the plan. Whereas new employees received a 5 percent salary contribution, the county provided current employees switching to the DC plan a 6 percent salary contribution. In addition, all DC enrollees were able to contribute up to 3 percent of their salary, which was matched by the county.

Current employees that had accumulated benefits under the DB plan had those benefits transferred to the DC plan. An actuary calculated the dollar value of their DB benefits before the county transferred those moneys into the employees’ new DC accounts.
What is an example of a “hybrid” plan?

Washington State established a new Teachers Retirement System plan that was a hybrid of the DC and DB models. Essentially, teachers in the plan:

- Receive a reduced DB benefit worth one-half of the original benefit; and
- In exchange, get a new DC account.

This DC account would be credited immediately with all of their employee contributions, plus a bonus of 65 percent from the state.
What entity would operate a DB or DC plan?

The same entity that operates the existing plan could operate a new plan. In the case studies cited on page 51, the same entity – the government employer – operates the old and the new plans. Although the employer would operate both plans, the DB pension board may have a limited role in overseeing the DC plan.

Alternatively, a new entity could operate the DC plan. For instance, local governments that are part of a statewide pension system could “opt out” of the existing system and form their own retirement plan. State law governs this area.
Why is employee education important for DC plans?

Employee education is critical in getting employees to participate in any retirement program. In addition, it performs two other important functions in a DC arrangement:

- It helps employees determine their risk/reward preference; and
- It guides employees in finding the investments that are in line with this preference.

Ultimately, employee education assists in achieving the goal of adequate retirement income.
Does the retirement system have experience in administering related retirement programs?

In converting to a DC system, employers and employees have to take on new administrative challenges, such as contracting out to a third-party administrator. Employers who operate related programs such as deferred compensation plans can draw on this experience to help them better manage a start-up DC plan.

In 1998, all 50 states operated deferred compensation programs, according to Employee Benefit Plan Review. The 1993 Public Pension Coordinating Council (PPCC) survey shows that 90 percent of local governments administered these programs as well. (The PPCC surveyed 400 state and local governments nationwide.)

Like other DC plans, deferred compensation programs allow an employee to manage several investment options within the employee’s segregated account. Deferred compensation programs usually supplement other retirement benefits.
APPENDIX A

Glossary

Actuarial accrued liability. The actuarial present value of benefits allocated to all periods prior to a valuation year.

Actuary. Finance professional who makes mathematical determinations of the financial condition of a retirement plan.

Annuity. Method of payment of retirement income by employer to a retired employee. The payment is made in a series of periodic disbursements for a fixed period or for the retiree’s life.

Contribution. Payment by an employee or an employer under a retirement plan to provide benefits or pay for costs in administering the plan.

Defined benefit plan. Retirement plan that fixes a plan beneficiary’s benefits (i.e., retirement income) based on a formula. The formula is often fixed at a percentage of salary.

Defined contribution plan. Retirement plan that does not fix a plan beneficiary’s benefits based on a formula. Instead, benefits are based on employer and employee contributions and related earnings.

Disability. Loss of earning capacity due to physical or mental impairment.

Fiduciary. An individual, corporation or association to whom certain property is given to hold in trust according to a trust agreement.

Fiduciary responsibility. A legal requirement that a fiduciary execute duties with care, skill, prudence, diligence, and in the exclusive interest of plan participants and beneficiaries.
Liabilities. The financial obligations of a retirement plan.

Lump-sum distribution. A one-time payment of retirement benefits. In contrast, an annuity pays benefits over several periods.

Portability. The ability to transfer the value of accrued benefits from one plan to another when the worker terminates his or her employment.

Vesting. The creation of an employee’s right to a retirement benefit, effective upon years of service or other criteria. This right may not be forfeited because of premature separation from service.
APPENDIX B

GFOA Sources

The following materials from the Government Finance Officers Association (GFOA) were used as reference sources in the preparation of this booklet.


APPENDIX C

Other Sources

The following materials were consulted for supplemental reference in the preparation of this booklet.


“Public Sector Employees Have the Power to Choose.” American Savings Education Council.


Other titles in GFOA’s series of booklets for elected officials include:

**An Elected Official’s Guide to Investing**
(by M. Corinne Larson)

**An Elected Official’s Guide to Procurement**
(by Patricia C. Watt)

**An Elected Official’s Guide to Financial Reporting**
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**An Elected Official’s Guide to Auditing**
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**An Elected Official’s Guide to Debt Issuance**
(by J.B. Kurish and Patricia Tigue)

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