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Before the New Hampshire House Special Committee on Public Employee Pension Reform
January 27, 2012

We are in the middle of a retirement crisis. Most Americans working today will enjoy less retirement security than their parents, a historic reversal that predates the market downturn, which only made a bad situation worse.

In a recent Gallup poll, six out of ten older Americans said they feared depleting their assets more than they feared *dying*. Unfortunately, they – and younger workers – have good reason to be scared. According to the Center for Retirement Research at Boston College, half the early Baby Boomers face a significant drop in living standards in retirement, even if they draw down every last penny of savings, including home equity. It's even worse for their children, most of whom will have to rely on 401(k) savings rather than secure pensions. According to the Center, seven out of ten GenXers will likely see a significant drop in living standards in retirement.

All told, the Center estimates that American households age 32-64 have a retirement income deficit of \$6.6 trillion, a conservative estimate that nonetheless dwarfs the federal deficit. This sum comes to \$90,000 per household on average, and assumes workers will continue to work, save, and accrue benefits up to age 65. It also assumes there will be no further cuts to Social Security or pensions.

The two main reasons for this dramatic increase in retirement insecurity are the shift from traditional defined benefit pensions to 401(k)-style defined contribution plans in the private sector, and the gradual increase in the Social Security retirement age, which is equivalent to an across-the-board benefit cut. The first of these factors is the main reason we're here today. State and local governments in New Hampshire and elsewhere are under pressure to follow the lead of the private sector in switching to defined contribution plans.

But it's important to keep in mind that we're talking about cutting pensions at the same time the Social Security replacement rate is also shrinking. Taking into account the increase in the normal retirement age from 65 to 67 as well as Medicare deductions and income taxes paid on benefits, the net replacement rate for the average earner retiring at 65 is scheduled to drop from 39% to 28% in two decades, and there's talk of further cuts. Thus, for teachers and state and municipal employees in New Hampshire, any pension cuts would be compounded by Social Security cuts.

The stock market lost more than half of its value between 2007 and 2009, draining nearly \$3 trillion from 401(k)s and other individual savings plans and over \$2 trillion from defined benefit pensions (roughly half of that from public sector pensions). Meanwhile, the bursting of the housing bubble wiped out trillions more from household balance sheets, and the economy began shedding millions of jobs. Though the market has since rebounded, individuals and pension funds are still rebuilding. The difference is that pension funds, especially public funds, have decades to amortize these losses, whereas individuals in or approaching retirement are out of time and out of luck.

In a rational world, we'd be looking at which parts of our retirement system are best able weather such storms, and building on those. Unfortunately, the reason we're here today is that the two strongest parts of our retirement system, Social Security and defined benefit pensions, are under attack, while

401(k)-style accounts, which were a failure even before the economic downturn, are touted as the best we can afford in hard economic times.

But if there's one thing we *can't* afford, it's relying on 401(k)-style plans, which cost nearly twice as much as defined benefit pensions to achieve the same outcomes. There are parallels to health care, where large employers (or large groups of smaller employers) and the government can provide benefits more cheaply to groups of workers than individual workers can obtain for themselves. As I'll explain later, the cost-effectiveness of defined benefit pensions is due to economies of scale, risk pooling, and other factors.

The fact that individual savings plans are poorly designed to serve as a primary investment vehicle isn't surprising when you consider that these plans were never intended to serve as primary retirement vehicles for ordinary workers. Congress added Section 401(k) to the Internal Revenue Code in 1978 primarily to give Wall Street workers and others who receive year-end bonuses the option of deferring these bonuses into profit-sharing plans. Over time, however, employers began using these and similar plans to offer tax-advantaged retirement savings plans to other employees as well.

The advantages of defined benefit pensions are especially clear in the public sector, where there's a large and stable workforce and where good pensions partly make up for lower pay. Teachers, for example, typically earn about 20% less per hour than comparable college-educated workers (even less per year, factoring in unpaid summers off) but at least they can count on a secure retirement.

This isn't accidental. A large body of research has shown that teachers are more effective after they've been teaching for at least three to five years, so pay and benefits—notably pension benefits—are designed to promote teacher retention through their years of peak effectiveness. Simply put, the longer a teacher stays with a school system, the better schools can recoup the sunk cost of on-the-job training. Conversely, pensions can also be designed to encourage retirement past a certain age. There are fairly obvious reasons for this in the case of firefighters, for example, but even teachers' pensions were initially viewed as a way of easing out "superannuated" teachers who remained in the profession only because they had no other option.

In the private sector, we're seeing a return to the days when older workers clung to jobs out of sheer desperation. Unlike workers and retirees with secure pensions, Baby Boomers with 401(k)s saw their already meager nest eggs crack open just as they approached retirement age. The result? Older workers putting off retirement even as jobs became scarcer, thus increasing the unemployment rate of young and old alike. During the Great Recession, the unemployment rate among older workers was the highest on record.

Like Social Security, defined benefit pensions provide guaranteed benefits that aren't affected by the stock market. This means workers can retire as planned regardless of the state of the economy—or they can retire earlier than planned if they lose their jobs. Thus, defined benefit pensions serve as automatic stabilizers for the economy, whereas defined contribution plans exacerbate swings in the unemployment rate.

(Note that a worker's decision to retire early doesn't affect Social Security's long-term finances since monthly benefits are reduced to keep lifetime benefits the same. The same is generally true of defined benefit pensions, though some are designed to encourage early retirement for various reasons, such as declining productivity for workers in stressful or physically demanding jobs.)

Though public pension funds were hit hard by the stock market downturn, this is more a political problem than a practical one, since these pensions are designed to ride out market fluctuations. Defined benefit pension funds, especially those in the public sector, have long investment horizons because they pool the retirement savings of workers who retire during bull and bear markets. In any given year, pensions pay out only a small fraction of their reserves in benefits. The New Hampshire Retirement System, for example, paid out about 10% of its assets last year in benefits (while earning roughly double that in investment earnings). So even in the wake of a once-in-a-lifetime stock market and economic collapse, the worst that can happen in most cases is that contributions will need to increase to amortize the unfunded liabilities over decades, which is the situation we're in today.

There are some exceptions to this rule, as with the Rhode Island, which faced an imminent funding crisis due to chronic past underfunding. This was also a contributing factor in New Hampshire, though the situation here is not nearly as extreme. In New Hampshire, the funded ratio went from 67% in 2007 to 58% in 2009, roughly where it stands today (57%). The low funded ratio even at the market peak was due to a switch to a more conservative accounting method in 2007. Unfortunately, this prudent move was immediately followed by the stock market slide, and by two years when only three quarters of the actuarially required contribution was paid. In addition, strong investment returns over the past two years were offset by lower assumed returns going forward.

Though the New Hampshire Retirement System now has a bigger hole to fill, it's important to keep in mind that only a few decades ago most public pensions operated on a pay-as-you-go basis, so we should be looking at this as a glass more than half full rather than nearly half empty. In any case, the practical implication is that required contributions have increased by roughly half over the past four years (more for teachers and state and municipal employees, less for police and firefighters). Much of this increase has been borne by workers, who shoulder roughly a third of the overall cost.

This is a significant increase, but the problem won't go away by switching to a defined contribution plan. As an independent actuarial study pointed out, it will just get worse. According to the report by Gabriel Roeder Smith, contribution rates would actually be higher under the proposed 414H plan than the normal cost for new members in the current defined benefit plan. And because returns will likely be lower due to more conservative asset allocations, the funded ratio would actually decline from 57% to 51%. Meanwhile, the employer contribution rate would increase by roughly 4% due to an increase in the normal cost as well as the cost to amortize the unfunded liability. The cost of administering two plans will also be higher.

Despite these higher costs, the new plan will deliver smaller benefits over the long run, though individual workers in any given year might do better. According to the actuarial report, "The proposed DC plan would likely provide retirement benefits that are near to or lower than those provided under the current DB plan for career members." The report estimates that the income replacement rate would be anywhere from 13 percentage points lower to roughly the same as with the current defined benefit plan.

As I mentioned earlier, this is in line with research by EPI, the National Institute of Retirement Security, the Center for Retirement Research, and others showing that defined benefit pensions are more cost-effective than defined contribution plans. One of the main reasons is that individual savers must choose between high risks or low returns. In contrast, pension funds can base contribution rates on average expected returns, because they have overlapping generations of workers and retirees who retire at

different times. As a result, it's rational for individuals to invest more conservatively than pension funds, and many do. Those who don't are lulled by the mistaken but widespread belief that cumulative returns average out over time.

Individual investors may have dramatically different outcomes depending on whether they retire during bull or bear markets. Even 401(k) participants who make relatively conservative investment decisions over a long time horizon are subject to unacceptable risks. Gary Burtless of the Brookings Institution has estimated that a 401(k) participant who contributed 4% of her wages over 40 years and invested the funds in a portfolio split equally between long-term government bonds and stocks would be able to replace a quarter of her pre-retirement earnings if she retired in 2008. This replacement rate is only half as much as a similar worker who retired in 1999, but much better than a worker who retired in 1974, who would have a dismal replacement rate of only 18%. Similarly, simulations by Patrick Purcell of the Congressional Research Service indicate that 401(k) participants who adopt a lifecycle approach—gradually reducing their exposure to stocks as they approach retirement—also face a significant risk of not being able to maintain their standard of living in retirement.

This problem is exacerbated by poor investment decisions, as most defined contribution plan participants do not have the financial expertise to manage their investments. It has been extensively documented that participants fail to optimally diversify and often make poor investment decisions. They tend to have an all-or-nothing approach to risk, with one in five investing nearly all their account balances in stocks (either directly or through mutual funds), and two in five investing none in stocks. The Center for Retirement Research has estimated that net investment returns are a full percentage point higher for defined benefit pension plans than for defined contribution plans, despite a lower concentration of funds invested in equities. With compounding, this small-sounding difference can translate into a 30% larger nest egg at retirement.

Besides poor investment decisions, such as buying high and selling low, another reason for individual investors' poor performance is that most defined contribution plan participants bear much higher investment costs than those paid by defined benefit pension plans. A survey of 80 providers found that annual fees could range from about 0.5% to 2.5% of assets for 401(k) plans. This is partly due to poor fee disclosure and the fact that plan providers are chosen by employers while workers bear most of the costs. But an individual account system is also inherently more costly to manage than pooled funds because of economies of scale. The problem of high fees and poor disclosure is bad enough in a voluntary 401(k) system—workers can theoretically opt out—but it could be even worse in a mandatory system like the 414H plan proposed for New Hampshire public employees.

Pooling also allows defined benefit pension funds to insure individuals against the risk of outliving their savings. Unlike individual savers, who need to prepare for the possibility that they might live to age 90 or even 100, pension funds need only set aside enough to cover average life spans. Though individual savers can convert account balances into lifetime streams of income at retirement by purchasing annuities, this is expensive because insurance companies assume that only someone with a higher-than-average life expectancy would purchase a life annuity. This problem would be mitigated, but not eliminated, by the fact that the proposed legislation calls for the automatic annuitization of half of account balances.

Given that defined contribution plans are less cost-effective than traditional pensions, the only way they can save taxpayers money, in New Hampshire or elsewhere, is if workers for some reason prefer defined

contribution plans, or if it's possible to slash the pay of public sector workers without affecting recruitment and retention.

The first might have been true for at least some in the go-go years of the dot-com bubble, but it's certainly not true today. Surveys consistently show that workers strongly prefer secure pensions over defined contribution plans, and this has been borne out in states where public employees have been given a choice. As for the second possibility, that pay can be cut without any adverse effect on recruitment and retention, this has been refuted by a number of studies, including several published by EPI, showing that public sector workers receive lower—or at least no higher—total compensation than comparable private-sector workers, even factoring in better pensions and other benefits. The only study I'm familiar with that makes the opposing claim is a deeply flawed study of teacher pay by researchers at the American Enterprise Institute and the Heritage Foundation, which, among other things, compared teachers to private sector workers who were much less educated on average.

In short, the proposed legislation will greatly lessen the retirement security of New Hampshire public employees without improving the finances of the state's public employers in any meaningful way. Employees and retirees, who are less able to weather financial trouble than government employers, will be forced to bear the risk of investment losses, from which many might be unable to recover. Public employers will be better off only in the sense that employees will bear all the investment risk.

Other New Hampshire residents will also pay a price. A switch to a defined contribution system will tend to exacerbate business cycles and increase hardship among seniors. This would lead to increased outlays on fuel assistance, Medicaid and other means-tested government programs. The only clear winners will be financial services providers who receive higher fees for their services. This might help the economy in New York or Boston, but not in New Hampshire.

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Note on why 401(k) plans are nearly twice as expensive: This estimate is from the Retirement USA report, "Toward a Universal, Secure, and Adequate Retirement System," which was vetted by actuary Ron Gebhardtsbauer. NIRS has found similar results. To attain a target 40% replacement rate for a worker who retires at 65 after 40 years of work, employer and employee contributions to a 401(k) would need to equal 14.5% of earnings, nearly double the 7.7% contribution rate required for a worker in a traditional pension. This difference is based on three assumptions: that pooled and professionally managed assets yield higher returns net of investment and administrative fees (7% rather than 6%); that 401(k) participants would gradually reduce stock allocations until they're invested only in fixed-income securities with a 5% yield at retirement; and that individual savers need to prepare for the possibility of a longer-than-average life expectancy at retirement (25 years rather than 21).