The Prospect of Liberty in Kansas Pension Reform

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Executive Summary

Kansas government workers at both the state and local level must currently participate in a retirement plan known as the Kansas Public Employees Retirement System (KPERS). It is a traditional *defined benefit* (DB) arrangement which is common among governmental units throughout the U.S., but which has begun to give way to the popular *defined contribution* (DC) system, such as a 401(k) plan, which millions of private sector employees have embraced for many years. Notable precedents have been set by other states which have created DC alternatives for their workers to consider...precedents which Kansas should follow.

The current Kansas DB program provides a guaranteed lifetime retirement benefit for employees who become vested in the plan by serving at least ten years in government service. This commitment to retirees is satisfied through past and current contributions by employer governments and their employees, plus market earnings on those contributions. However, within the 40-year period for which KPERS' must estimate its obligations, the payout is expected to exceed anticipated revenues by more than $1.5 billion -- the *unfunded liability* of the program -- and the ultimate guarantors are taxpayers.

While the unfunded liability issue is a strong impetus for change, there are many other reasons why both taxpayers and government workers would be better served with a new optional DC program. First, there is no unfunded liability for any workers covered under a DC plan. Other advantages of DC include: greater ***portability*** of retirement plans when changing from one job to another; greater retirement ***benefits*** for most workers; faster ***vesting*** by workers in employer contributions; employee ***ownership*** of funds in their retirement accounts (and the advantages which come with that ownership); substantially reduced ***discrimination*** that stems from inherent limitations with any DB program; and other attractive features.

DB programs have been workable mechanisms for providing retirement income to millions of people. The KPERS DB plan should be kept intact as an option for those workers who conclude it to be in their best interests, particularly vested workers within ten years of retirement. However, those who deem that a DC program provides them with the best financial future should be given that option; and as that DC choice is increasingly selected, such workers simultaneously improve the solvency of the remaining DB program for others.

Introduction

By KPPI President Bob L. Corkins

This report focuses on the merits of a particular breed of pension plan known as *defined contribution* (DC). While DC retirement plans are very commonly provided today by private sector companies for their employees — such as the 401(k) plans in which millions of American workers are participating — government employers have been much slower to embrace them. Kansas is no different from the vast majority of other states in its reliance upon a very different type of pension program known as *defined benefit* (DB).

These two dominant types of pension plans, DB and DC, each derive their name from the nature of the plan. DB programs have a single trust fund and literally *define the benefit* a retiree will receive upon retirement. It is based on a formula that uses the given retiree's tenure, final salary, and other factors. DC programs, however, merely *define the contributions* made into each individual's account by the employee

and employer. DC retirement benefits are driven by the size and investment earnings of those account contributions.

DB retirement plans are clearly the norm for public sector workers. Because the purpose of this paper is to discuss an improvement to the status quo, we therefore take a promising alternative, in this case the DC approach, and test it against the norm. While there are many shortcomings and inequities of DB plans for large groupings of employees, some workers will nevertheless find the current DB system to their advantage and they should be allowed to keep it. Consequently, rather than mandate that all government employees participate in a DC retirement plan, we will elaborate on the policy of offering each employee a choice.

KPPI submits this report by Mr. Mowbray as part of our organization's continuing involvement in the state and national pension reform debate. As the following arguments unfold, you'll see many similarities between this Kansas issue and the national prospects for saving Social Security. You will also see how squarely aligned such pension reform ideas are with KPPI's mission of advancing liberty, limited government, personal responsibility, and free markets. Please don't hesitate to turn to KPPI for additional background and watch for additional research from us on this topic in the months to come.

The Nature and Contrast of Pension Concepts

Defined Benefit Plans

DB pensions are the traditional retirement systems that have been dominant in employee organizations and larger businesses for most of the past 50 years. They are still widespread in the public sector, with 90 percent of state and local government workers in the U.S. being currently enrolled in DB plans.

DB programs guarantee a fixed retirement income for the remainder of a participant's life. Surviving spouses sometimes have rights of survivorship, meaning they can have the DB retirement income assigned to them for the rest of their lives. In essence, DB plans function as annuities for people who live to the eligibility retirement age specified in the plan.

A natural counterweight to DB's predictability is that such programs lack flexibility. A key concern in this regard is that DB pensions are not very "portable" when moving from one job to the next, particularly if moving between public and private sector employment. The worker who stops participating in a DB plan has no account balance which can simply be rolled over into the next job's retirement program or an independent retirement account.

Flexibility also suffers because most DB plans have stringent vesting requirements, typically a minimum of 5 to 10 years tenure before a worker is entitled to any benefits upon retirement. Prior to retirement, DB participants have no equity stake in the plan assets. This limits plan flexibility by denying employees the chance to take out loans using retirement funds as collateral or the option to receive emergency hardship distributions from the fund itself. In other words, employees have no in-service access to their pension funds.

Although employee access is denied to DB funds, few, if any, pension responsibilities are thrust upon participating workers. Conversely, a DB system brings extensive employer responsibilities because DB plans are managed by the employer or plan sponsor. Contributions are deposited into a single trust fund, which is also the fund that pays benefits. The employer assumes all of the investment risk and is also saddled with cumbersome administrative duties.

Of course, in the case of public sector DB programs, the employer is government — which means taxpayers are bearing the investment risk and DB administration adds to an already imposing bureaucracy. Such administrative obligations include actuarial services, accounting services, bonding, and investment management. Record keeping is also ponderous. DB pension employers must maintain

records of every living current or former vested employee, even if a worker had left for a different job decades ago.

Actuarial responsibilities are particularly complicated. In DB systems, the plan sponsor must hire actuaries to estimate future liabilities, an ongoing task of economic predictions, prediction modifications and the statistical review of workers' experience. Actuaries must evaluate whether DB plan income will satisfy plan liabilities for as many as 40 years into the future. To illustrate the difficulty of this essential chore: 30 years ago, nobody could have accurately predicted the advances in medicine and technology that have expanded life expectancy today, thereby increasing DB plan liability. Societal and economic change is indeed rapid, demanding the same adaptive quality of a reliable pension structure.

KPERS Defined Benefit Plan

The state of Kansas requires its public employees and those of local governments to participate in a defined benefit (DB) plan. Currently, an individual must pay 4% of his or her earnings into the state's defined benefit trust fund. Technically, each worker vests immediately in his or her own contributions, but is not entitled to the earnings on those contributions by the Kansas Public Employees Retirement System (KPERS) trust fund. The state also contributes an amount into the trust fund, based upon actuarial estimates of the amount necessary to pay promised future benefits. The state of Kansas and local school districts presently contribute somewhat less than 4% of their employees earnings due to statutory growth caps plus an additional rate to address part of KPERS' unfunded liability. However, an employee must work in public service for at least 10 years before he or she vests in the state's contributions.

Normally (and naturally) investors demand a fair rate of return on the use of their money. Calculating a rate of return, however, is impossible to do on an individual basis for defined benefit plans. Rates of return can only be calculated for the aggregate, because a DB program has no investment component as far as the employee is concerned. Nor is the full payout known until the DB retiree dies and benefits cease. DB pensions are thus essentially insurance programs because individuals have no equity stake. Furthermore, a pensioner's retirement income is dependent upon the political process. The legislature decides the formula to be used in calculating benefits and whether cost of living adjustments to pension income will be provided.

Granted, the Kansas Supreme Court has ruled, on several occasions, that the state owes a contractual duty to retirees, and that benefits cannot be reduced short of some offsetting change. Although benefits cannot be reduced, retirees don't necessarily enjoy any of the higher-than-expected DB investment returns either. For example, despite a 5-year rate of return of 13.4% for the total KPERS fund, retirees have seen no increase in benefits other than occasional cost of living adjustments. Government and taxpayers benefit from this because greater investment earnings lead to lower employer contributions.

DB plans may extend superior benefits if you are a career employee who retires at age 65, after which you live a much longer life than the average retiree. DB plans are not a bargain if you start your career in public service and then leave for any meaningful stint in the private sector before retiring. In the second case, you would earn no interest on your pension fund, and the income level used in the benefit formula is not adjusted for inflation.

Discriminatory Aspects of DB

This is the nature of a DB program: an annuity benefit for every year an individual lives past retirement age. As a result, DB programs most greatly favor white females who have continuous work histories because, statistically, such people have the longest life expectancies. On the other hand, black males receive the lowest retirement returns as a group because they have the shortest average life expectancies.

DB plans are also regressive in nature. According to the federal government report, "Health, United

States, 1998," longevity is directly related to income level. The poorest workers have the shortest life spans and each successive economic group has a longer life expectancy. Although every employee pays the same percentage of salary into the trust fund for each year of employment, those who live the longest enjoy the greatest return. Since wealthier participants tend to live longer, DB plans are regressive in the aggregate. This factor characterizes DB pensions as essentially being wealth transfers, transferring money from poorer to wealthier individuals, from men to women, and from blacks (in particular) to all other racial categories.

As long as DB participants live well beyond retirement age, the risk to their financial return is negligible. They have a formula-driven retirement income that is guaranteed by statute. If the trust fund falls short, the legislature can use general tax revenue to supplement the trust fund in payment of retirement benefits. The legislature has not had a need to step in recently, given the 10.25% rate of return the KPERS trust fund has enjoyed over the 10-year period from 1988-1997.

Likelihood of Vesting

Even healthy workers who are likely to beat the life expectancy odds must consider whether they will eventually be entitled to DB benefits. At question is their probability of working at least 10 full years in KPERS to become vested in the plan. In fact, official projections odds show that the large majority of those who start working today at the state and local level will never become vested. This means when they leave their government jobs, they will receive the equivalent of their personal contributions to KPERS plus four percent interest — no entitlement to pension benefits, no employer contributions, and no market earnings on their money.

Certain categories of employees are much less likely to vest than others. Those least likely to remain at work after ten years are females starting now under age 25 in state employ. The latest statistics indicate that only 11% of these women will vest in KPERS. Even the group most likely to vest, females beginning work today for a local school at age 45 and above, will still lose over 40% of their ranks before ten years have gone by.

The argument that individuals vest immediately in their own contributions into the DB system should provide small comfort. In fact, when an individual seeks a lump sum payment, he or she gets back the actual payments plus interest, based on a legislatively-determined rate. For workers hired after 1993, that interest is accrued annually at the rate of 4%. That means that if a 5-year employee, hired in 1993, would like to take a lump sum payment for all of his contributions plus interest, he would have received 57% more if he or she had been credited with the 13.4% return that the KPERS trust fund has earned during that period. For every $10,000 that worker could receive under current rules, he or she would have received $15,700 if the interest on the individual’s contributions equaled the rate of return of the KPERS fund.

The other major type of pension system is a defined contribution (DC) plan. Like the name suggests, the contributions into an account are definite, as opposed to having a pre-set benefit.

DC plans come in various incarnations and have many malleable features. Plans can be set up with only a mandatory employer contribution and voluntary employee contributions. Often, employers match voluntary employee contributions up to a certain limit. Because individuals own their contributions and also own employers’ contributions upon vesting, they can (if the plan allows) borrow against the value of their account. DC systems can also allow various types of in-service access: hardship distributions, loans, and in-service withdrawals at certain ages. Retirement age under DC plans is set by the individual, not the program administrator, because the account is owned by the individual. In short, plan options and variations are almost limitless.

In our changing economy, more and more employers are turning to DC pensions. Most people have at least heard of the most common DC account, a 401(k). The number of new DC pension plans created in

the last 20 years dwarfs the number of new DB plans, and there are now more people enrolled in DC plans than in DB programs. That private sector trend is now spreading to government as an increasing number of state legislatures are turning to DC retirement systems for an alternative.

Workers like the tangible and simple to understand characteristics of 401(k)s. Having personal ownership over the retirement account is its critical attribute. Quarterly or monthly statements keep participants updated on the growth of their retirement accounts and provides a powerful incentive for increased personal savings.

Thus, while DB plans serve as large-scale insurance programs for workers who live to retirement age, DC plans create new wealth for each individual involved. Participants own the assets in their accounts, and the value of these accounts are not compromised if participants die before drawing a certain level of retirement benefits. That wealth can also be passed on to children and grandchildren because the money belongs to the individuals.

Unlike defined benefit plans, DC plans allow for an accurate assessment of rates of return for every individual involved. An employee vests immediately in personal deposits into the account, and earns the full rate of return instantly, instead of receiving a nominal interest rate set by the legislature.

Vesting and Portability

Employees vest immediately in personal DC contributions, but employers have some flexibility in determining the vesting requirements for employer contributions. For 401(a), government-sponsored DC plans, vesting cannot be more stringent than 5-years cliff vesting (full vesting at five years tenure) or 3/7 graded vested (20% vesting at year three, an additional 20% per year ending in year seven). Vesting requirements for employer contributions can be, and often are, less stringent for the employee.

Because employees have ownership immediately in their personal contributions and the full earnings of those assets, DC systems allow true portability. Workers can take their pensions from job to job or deposited into an independent retirement account while their retirement funds continue to grow from compounding interest throughout their working careers. Unlike a DB plan where you can personally earn no returns on your investments, DC accounts grow no matter where the person goes after leaving the employer. Individual ownership also allows DC plans to be structured to grant in-service access to plan participants. Employees may take out loans or receive hardship distributions while they are still employed.

Most often, employees fully vest within 4 years in the employer contributions, and partially vest within one or 2 years. If someone decides to leave employment, he or she is able to take the pension to the next job. This feature, known as pension portability, is a huge asset in responding to an increasingly mobile workforce. With pension portability, an employee has the freedom to take a lump sum payment or roll over the value of a DC account into an IRA or into a new retirement program at his or her next job.

Portability also makes DC programs less cumbersome and bureaucratic on the administrative side. Participants manage their own accounts, usually with the help of professional advice, so there is no guesswork on the part of the employer to satisfy a liability that may or may not materialize in the future. In fact, pure DC programs save a considerable amount of time and expense for the employer because no actuarial projections or pension records of former employees are required.

DC plans provide an attractive option for a large segment, if not a clear majority, of public sector employees. Those who start public service at an early age, regardless of the duration of tenure, enjoy well-funded retirements primarily due to the factor of compounding interest. Because dividends and capital gains are reinvested into the DC account, accounts grow exponentially over time. DC accounts earn money and grow continuously — even if an individual has not been continuously employed.

Addressing Discriminatory Effects

Minorities and lower-income individuals also fare substantially better under DC systems in the aggregate. No matter how long they live past retirement, or even if they do not live to retirement age, individuals do not lose out on benefits. If someone wishes, the remainder of the pension fund can be bequeathed to his or her estate.

DC plans provide a great equalizing opportunity for lower-income and lower middle-class individuals because of the potential for amassing hundreds of thousands of dollars, in today's dollars, in net equity by the time retirement starts. Assuming a conservative 7% rate of return, a lifetime $20,000 a year worker, saving just 6% of his or her annual salary, would amass $380,000 (in today's dollars) by age 65. DC programs thereby grant the freedom necessary to equalize retirement opportunities. Retirees can choose to use their savings to buy a house, start a business, use a portion for an annuity for a guaranteed income stream, or pass the remainder on to their spouses and children.

Since a DC program creates wealth, rather than transferring wealth, it is not a zero-sum game. Every individual can accumulate an impressive and security-providing sum of money to the detriment of no one else. In fact, employees in a DC system have incentives to increase their level of savings. Most DC plans allow employees to invest up to the federally allowable limit (the lesser of 25% of compensation or $30,000 per year), although the level of matching funds put up by the employer varies widely. Consequently, employer matching funds that rise along with those of the employee's cause individuals to associate payroll deductions under a DC plan as savings in their retirement accounts.

Investment Risk

DC accounts have a wide array of investment options: stocks, bonds, mutual funds, and REITS among others. Returns in the private market are a key factor in the success of DC systems -- just as they are a key factor for aggregated DB funds. Over the past 70 years, a period that includes the Great Depression, several recessions, and the stock market correction of 1987, the Standard and Poors 500 Index has an annual rate of return of 7.75% after inflation.

Skeptics will ask "what if the market crashes?" or "what about people who don't know how to invest?" The simple answer is that retirement accounts are held over a 40-45 year period, market crashes do not wipe out everything and the market has always rebounded before. Even after the 1987 stock market crash, the worst single-day percentage drop since 1929, stocks regained all the lost value before the end of the year.

For those who aren't convinced, or for those who plan to plan to invest for a relatively short period of time, an even simpler answer is to refrain from investing in equities. Bonds, annuities, and other fixed-return investments are always available as options to fill part or all of any given portfolio in order to provide the desired level of security.

Another consideration for unsophisticated investors is that professionals will manage their stocks. Mutual fund selections leave the daily buying and selling of specific equities to competent, reputable investment firms that have been pre-approved by the DC employer.

There is, of course, the risk that individuals will invest too conservatively. To combat risk-averse tendencies, a plan administrator can offer several model portfolios while assisting employees with their investments. Also, many employers offer varying levels of education to increase the financial savvy of plan participants.

Overview of DB and DC

In considering the pros and cons of both DB and DC pension programs, it is important to keep in mind the nature of each. DB plans are essentially large-scale insurance programs, designed to provide annuity payments upon retirement and expose participants to extremely minimal risk -- and positive financial returns as long as they live well beyond retirement age. DC plans create wealth, offer portability, and display continuous growth toward a sizable nest egg upon retirement. Despite the fact that individuals bear risk with DC accounts, risk can be minimized through diverse portfolios and by following professional advice with a long-term perspective.

The Win-Win Scenario
Offered by Pension Reform

In 1997, California and Michigan revised their pension programs for state employees from defined benefit (DB) to defined contribution (DC). Following the lead of California and Michigan, eight state legislatures currently have pension reform bills pending for state employees, and 10 states have established groups to study the issue.

Michigan and California passed DC legislation after Colorado, Washington, Missouri, West Virginia, Alabama, and South Dakota had all established DC plans for specified classes of state workers. In December 1996, Ohio and Illinois enacted legislation providing a DC plan for employees of higher education institutions. Virginia enacted DC plans for school superintendents and select employees in the executive branch this spring, and Vermont recently followed suit by enacting DC plans for legislative staff and select executive branch employees.

Last year, the American Legislative Exchange Council (ALEC), a bipartisan national association of 3,000 free market state legislators and private sector members, drafted model legislation based on the Michigan and California bills already signed into law.

Such proponents are inspired by the proliferation of 401(k) plans in the private sector, largely because employees can realize higher retirement incomes with a well-tailored investment portfolio than they could realize under a traditional DB pension. In fact, the number of DC plans created in the last 20 years dwarfs the number of new DB programs. In 1975, DB plans accounted for 103,000 of the 311,000 total plans. By 1992, the number of DB programs had fallen to 89,000, although the total number of plans in the private sector had risen to 708,000.

Another reason governments are considering or have established private pensions in 23 states are the benefits which they, as employers, receive. By its very nature, a DC system can have no unfunded liability, thereby avoiding the temptation to public officials who might promise higher future benefits without providing adequate pre-funding for such higher benefits. Also, with the rapid expansion of 401(k) plans in the private sector, states are at a recruiting disadvantage when they cannot offer a DC plan. In today's highly mobile work force, workers are discouraged by the restrictions of DB systems: lengthy vesting requirements, no wealth creation, no portability, and no in-service access or distributions.

As the public sector increasingly realizes, defined contribution plans offer a win-win scenario: workers receive higher pension payments while the state reduces future liability and gains a powerful recruiting tool.

Worker Benefits

Although public sector employees tend to have a lower turnover rate than the private work force, a large portion of civil servants do not work long enough to meet DB programs' lengthier vesting requirements. High mobility of the workforce is quite apparent from data found in the 1990 Census: the mean tenure of a local government worker is 9.3 years, workers average 7 jobs during their career, and fewer than 25% of employees reach 20 years of service with a single employer.

In Michigan, for example, nearly two-thirds of public school employees earned no retirement benefits and only 55% of other state employees received retirement benefits under the old DB program.

In Kansas, the hired actuarial firm for the Kansas Public Employees Retirement System (KPERS) has generated estimates which are comparable to the Michigan vesting experience. The following table displays vesting probabilities for various categories of workers. For each segment of government — state, local, and schools — the trend shows that the older one starts in public sector work, the more likely one will vest.

Kansas Public Employees Retirement System
Probability of Vesting for New Hires

School Employees - Males

Under the Age of	% Remaining after 5 yrs	% Remaining after 10 yrs
25	40.1	25.0
30	45.1	33.1
35	48.5	38.5
40	49.6	40.4
45	50.8	43.2
50	52.1	46.2

School Employees - Females

Under the Age of	% Remaining after 5 yrs	% Remaining after 10 yrs
25	37.8	19.9
30	45.8	30.2
35	52.5	39.2
40	60.3	50.5
45	64.1	57.7
50	65.1	58.8

State Employees - Males

Under the Age of	% Remaining after 5 yrs	% Remaining after 10 yrs
25	35.5	15.8
30	46.1	28.7
35	52.1	38.2
40	56.1	43.9
45	57.7	47.0
50	58.9	50.6

State Employees - Females

Under the Age of	% Remaining after 5 yrs	% Remaining after 10 yrs
25	31.4	11.1
30	41.1	21.7
35	48	30.8
40	52.0	38.4
45	53.6	41.5
50	54.4	43.2

Local Govt Employees - Males

Under the Age of	% Remaining after 5 yrs	% Remaining after 10 yrs
25	41.7	29.0
30	49.8	32.8
35	56.9	42.5

Local Govt Employees - Females

Under the Age of	% Remaining after 5 yrs	% Remaining after 10 yrs
25	35.8	21.1
30	43.9	25.9
35	49.3	31.9

40	63.0	50.1	40	53.6	38.3
45	66.2	54.3	45	55.5	42.9
50	67.1	56.1	50	56.1	43.4

These percentages for discreet groups also refer to a big number in the aggregate. Of almost 129,000 active state, local, and school employees, over 39,000 have less than five years experience -- the years in which the highest attrition rates occur. For another way to view the statistics for workers with possible interest in a DC retirement option, we find that almost 58,000 are people under age 50 who have not yet vested in KPERS.

Under a DC system, however, employees vest immediately in individual contributions and have much quicker vesting in the state's contributions. Compared to the common ten-year vesting requirement found in DB programs, a DC plan affords a substantially larger section of state employees the opportunity to gain retirement benefits. Because of compounded earnings, typical workers with modest salaries are easily capable of building attractive pension incomes.

Benefit Comparisons

For comparison's sake, we'll assume a 40-year-old leaves state employment after 10 years of public service, that he had a starting annual income of $40,000 which experienced a 2% real (inflation-adjusted) annual growth, and that he plans to retire at age 65. Under the current DB plan in Kansas — which uses a formula of 1.75%, times the last three years average salary, times years of service — that retiree would receive an annual income of $8,367.

This example illustrates a common situation of workers who leave public service before retirement. Because the state formula neither adjusts the average annual salary for inflation nor accounts for accrued interest during the latent period (the time before retirement during which the individual is not employed by the state), the DB plan begins to lose ground to the constant investment activity of a DC account. In delivering a presentation to the Kansas Legislature, this point was acknowledged by a prominent national pension consultant stating, "for those who terminate prior to retirement, DC will probably provide the superior benefits."

The contrasting growth under a DC arrangement leads to a significantly better scenario. Staying with the same worker in our last example, for argument's sake, we'll assume that there is an employer contribution of 3% and a mandatory employee contribution of 4%, rates that are similar to the current contribution levels with KPERS. Remember, however, that actual DC plans can be structured from among dozens of contribution rate options.

Based on a total 7% contribution rate, that worker's annual retirement income, derived solely from the interest of the 401(a) principle, would be $24,900 (assuming an 8% rate of return -- the same rate used in KPERS' own actuarial assumptions). The remaining principle would be $311,250, the result of 25 years of compounding the principle earned during 10 years of employment.

If the worker had voluntarily contributed an additional 3% of his annual income throughout his tenure, without any state matching funds, his annual retirement income would be $35,571. The accrued principle would be $444,643.

Other common examples, including a comparison of DB and DC outcomes for a worker making a lifetime career of government service, are set forth below and in Appendix-B to this report. Again, the annual DC projections represent income from interest only and the corpus is left intact. Consequently, the examples remove the prospect that a retiree might outlive the funds in his or her DC retirement account.

Defined Benefit / Defined Contribution Comparisons

5 years employment

Assumptions	DB	DC
Leaves age 30 $30,000 starting salary Retires age 65	**$0/year**	**$15,667/year** plus **$195,832** principal

10 years employment

Assumptions	DB	DC
Leaves age 40 $40,000 starting salary Retires age 65	**$8,367/year**	**$24,900/year** plus **$311,250** principal

15 years employment

Assumptions	DB	DC

Leaves age 45 $45,000 starting salary Retires age 65	**$15,589/year**	**$37,044/year** plus **$463,052** principal

20 years employment

Assumptions	DB	DC

Leaves age 50 $55,000 starting salary Retires age 65	**$28,047/year**	**$53,570/year** plus **$669,623** principal

40 years employment

Assumptions	**DB**	**DC**

Leaves age 65 $25,000 starting salary Retires age 65	**$37,888/year**	**$47,184/year** plus **$589,799** principal

10 years employment		
ASSUMPTIONS	**DB**	**DC**
Leaves age 65 $60,000 starting salary Retires age 65	**$12,550/year**	**$5,454/year** plus **$68,174** principal

Those people who are likely to fare better in a DB plan are those who are already in state employ and are relatively close to retirement. Because the benefit formulas for DB plans factor non-inflation-adjusted salaries, people who finish their careers in public service do comparatively better than someone who left state employ 10 years prior to retirement. Also, a current employee nearing retirement would stand to double his annual retirement income in the last 5 to 10 years of service. Of course, again, positive DB results will depend on how long beyond retirement the pensioner lives.

Most DB to DC plan conversions, however, would not impact such workers. Typically, current workers are given the option to convert to a DC account, and only new hires are automatically enrolled in the DC plan. New workers, particularly young employees, are the greatest beneficiaries of a DC program because of the vast potential earnings growth through compound interest.

Finally, an individual who does not use the entire principle can bequeath the remainder to his or her estate. Because of the equity nature of a DC system, the individual's retirement account can outlive the person by being passed on to children and grandchildren.

Potential for Addressing Discrimination

Women, minorities, young workers, low wage employees, and short-term or recurring employees would be the greatest beneficiaries of a DC program. A recent federal government report held that minorities, lower-income and lower-middle income Americans have shorter life spans than the national median.

The inherent limitations of DB systems to address this relative pension inequity create an independent motive to consider an alternative. Discrimination is avoided under a DC approach because the workers have ownership of their retirement accounts. One's vested interest in a personal DC account is not eliminated upon death of self and spouse. Consequently, accumulated wealth is retained by the family or it goes to whomever the worker bequeaths it. The money is not absorbed into a larger pool for redistribution in a *defacto* discriminatory fashion.

People with non-consecutive work histories are disadvantaged under DB programs because of the stringent vesting rules. For example, women who start public service at a young age, but then leave to

devote years to child rearing, would be better served by a DC account which is continually reinvested on their behalf during an employment latency period. When such unvested workers return, they do have the right to buy back into KPERS. However, the expense of the buy-in and the lack of any pension investment growth during the period of leave will further weaken the DB plan's value relative to a DC alternative.

Young workers also would stand to gain significantly under a DC pension system. In today's changing economy, young workers change jobs more frequently and are considerably mobile as a group. DC plans are advantageous for this age group due to its substantially faster vesting provisions and the portability that allows market-value pension balances to be rolled over into new accounts.

Another burden placed on young workers who leave public service is caused by KPERS' failure to track individuals who leave state employ before retirement. KPERS essentially does not recognize discreet individuals until this point in time; their responsibility is focused on assuring the solvency of the overall fund. Records of active employees are maintained by their respective employer -- the city, county, school district or other governmental unit in question — but no state organization tracks workers once they leave Kansas public service.

Consequently, any vested person who leaves state employ before retirement must contact KPERS when turning 65 to claim benefits. If someone forgets that he or she vested (not always an easy task if someone spent the 30 years prior to retirement in the private sector), or he or she does not know how to claim benefits, then that person would not receive benefits owed him or her. The Kansas State Treasurer's office has recently refreshed its attempt to identify such beneficiaries, noting that more than 7,000 accounts holding over $25 million are currently lying unclaimed. Because of the individual ownership character of a DC account, periodic account statement mailings and other personalizing factors, the chance of unclaimed property accruing in a DC environment would be substantially less.

Relative Risks

Although the investment risk in a DC plan falls onto the plan participants, basic strategies for coping with market risks have been around for as long as there have been markets. While some pension investment decisions are more growth-oriented than others, retirement accounts are diversified and are held for long periods of time, making the risk of losing money or enjoying mediocre returns very slim.

DC pension security is also partly due to the widespread practice in the private sector of employers offering a finite list of investment options. They typically offer a select list of funds, such as stock funds, index funds (tied to indexes such as the Standard and Poors 500 or the Dow 30), bond funds, and real estate investment trust funds. Many employers offer several model portfolios for their plan participants to choose from. For example, the employer would plug in factors such as the individual's age, salary, current retirement account balance, and retirement needs into a formula or computer program to determine the best allocation of investment resources in different types of funds for that person.

In some respects, DC plans pose fewer risks to the participants' interests than would a DB arrangement. DC participants own the money in their accounts. Therefore, if a participant and spouse die before age 65, the money in the account stays within the family instead of reverting to the state pool, i.e., the decedents' heirs are more secure. For minorities, lower income individuals, or other categories with statistically lessened life expectancies, DC systems do not pose the risk of diminishing realized benefits. That is, they don't have to live to a certain age to achieve a positive return on their savings.

Government Pension Fund Liability

With lawmakers of both major parties wary of entitlement liability, pension reform allows states a means to reduce a large, future liability by providing workers a DC option. Lowering mortality rates, changing turnover rates and many other factors make it increasingly difficult to forecast long-term future liability with any degree of certainty. For example, KPERS announced this autumn that they had underestimated the

unfunded pension liability by $215 million dollars, bringing the total unfunded pension liability to $1.59 billion — over 20% of the $7.75 billion actuarial value of KPERS pension assets.

In simple terms, unfunded liabilities refer to that amount by which projected expenses will exceed projected income. To satisfy Kansas' pension obligations when the KPERS fund is not able, employer contribution rates must increase and/or state general fund spending must be approved to resolve the shortfall. Either way, taxpayers are the ultimate guarantor.

One reason for rising pension plan expenses is the growing number of retirees, part of the national "baby boomer" phenomena which certainly includes the public sector workforce. The current national rate of 200,000 past/present state employees retiring each year will climb to 1.6 million per year in less than 15 years. Other causes of higher pension costs are benefit enhancements, such as cost of living adjustments, and early retirement incentives. All such factors are converging to create large financial problems for states as evidenced by a Wilshire Associates study which reported that the average state DB pension system is only 92% funded.

Empirical evidence from counties in Michigan and states that have allowed current employees to switch to a DC plan suggests that, if anything, the remaining DB program is more funded after the DC alternative is created. This happens due to the selection bias among workers who choose to switch, for example, workers who have not vested or those whose vested amounts are relatively low. These groups which favor DC accounts are also those which represent the largest potential future liability for their current DB programs. Typically, if half of present employees change over to the DC plan, significantly less than half of the assets actually leave the DB coffers.

Another often overlooked benefit for states in switching to a DC plan is the improved bond rating that normally results. Without the potential unfunded liability of a DB system, bond ratings improve. Better bond ratings reduce the cost to raise capital and thereby save taxpayers money.

In an increasingly mobile workforce, DC pension systems have become a significant interest of job-seekers for many reasons: true portability; immediate vesting in personal contributions plus full market earnings; full vesting often in four years; account growth even during periods of unemployment; simple, tangible benefits over which one can claim ownership; the ability to pass an estate on to one's heirs; and, many other attractive characteristics.

Nevertheless, DB programs have been reliable mechanisms for providing retirement income to millions of people. Workers who have contributed to existing DB plans for many years and are now nearing retirement will probably be best served by holding pat. Investors simply must allow a minimum number of years, perhaps at least ten, for a DC account to experience sufficient compounded growth toward a meaningful nest egg. It is also likely that some people will accept virtually no risk for their pension and will insist on remaining with a DB plan even if a conservative DC portfolio offers significantly greater benefits. For them, the value of their peace of mind from sticking with something they've become comfortable with is quite high.

While DB and DC interests wrestle in the public policy arena, workers still need to make concrete plans for their retirement. Instead of debating whether one approach or the other is to be forced upon public sector employees, a superior course is to borrow the paradigm that works so efficiently in countless other economic contexts: allow people the freedom to act in their own best interests. Those deciding they are most advantaged by remaining with a DB plan should do so. Those who deem that a DC program provides them with the best financial future should have that option; and as that choice is increasingly selected, they simultaneously improve the solvency of the remaining DB program for others.

Policymakers will be facing increasing pressure to cope with huge unfunded liabilities in existing DB plans, including that of Kansas. Before a day of fiscal reckoning occurs which may coerce a specific

legislative action, a much less painful and more choice-enhancing pension reform concept is available to address the problem now.

How One State's Program Works: Michigan

Michigan granted its 63,000 state employees the option of changing from the former defined benefit (DB) program, in which one couldn't fully vest until 10 years, to the new defined contribution (DC) plan, in which a worker 100% vests within four years. An employee vests 50% at the two-year mark, 75% at the end of three years, and 100% after four years.

Any worker who commenced state employment after March 31, 1997, has been enrolled in the DC plan. State employees hired before March 31, 1997, who participated in the DB program, were allowed to enter the new pension system during the first four months of 1998, carrying over the net present value (NPV) of their DB pensions. The four-month window of opportunity closed April 30, 1998.

A mandatory state contribution of 4 percent of each employee's annual salary is made to a personal Defined Contribution Account (DCA), which is the functional equivalent of a 401(k). The state will further match, up to 3 percent of an employee's compensation, any voluntary contributions made by an employee. Thus, if an individual makes a 3 percent voluntary contribution, the total contributions to his DCA will be 10 percent of his annual compensation. (Calculation: 4 percent State contribution, 3 percent voluntary employee contribution, 3 percent State matching contribution.)

Workers may invest up to the federal limit, although those contributions beyond 3 percent will not be matched. DCA's are portable, and employee contributions and vested employer contributions, and the market earnings of both, can be taken by an employee once he leaves state employment.

Numbers Speak Louder Than Words

Based on a 4% employee contribution and a 3% employer contribution; assuming a 7% rate of return and a 2% real (inflation-adjusted) salary growth**.**

5 years employment		
Assumptions	DB	DC
Leaves age 30 $30,000 starting salary Retires age 65	**$0/year**	**$9,666/year** *plus* **$138,080** *principal*

10 years employment		
Assumptions	DB	DC

Leaves age 40 $40,000 starting salary Retires age 65	**$8,367/year**	**$16,421/year** *plus* **$234,590** *principal*

15 years employment

Assumptions	DB	DC	

Leaves age 45 $45,000 starting salary Retires age 65	**$15,589/year**	**$24,880/year** *plus* **$355,431** *principal*

20 years employment

Assumptions	DB	DC	

Leaves age 50 $55,000 starting salary Retires age 65	**$28,047/year**	**$36,572/year** *plus* **$522,461** *principal*

40 years employment

Assumptions DB DC

Leaves age 65 $25,000 starting salary Retires age 65	**$37,888/year**	**$32,269/year** *plus* **$460,984** *principal*

10 years employment

Assumptions DB DC

Leaves age 65 $60,000 starting salary Retires age 65	**$12,550/year**	**$4,539/year** *plus* **$64,836** *principal*

Based on a 4% employee contribution and a 3% employer contribution; assuming a 6% rate of return and a 2% real (inflation-adjusted) salary growth.

5 years employment

Assumptions	DB	DC	

Leaves age 30 $30,000 starting salary Retires age 65	**$0/year**	**$7,764/year** *plus* **$97,052** *principal*

10 years employment

Assumptions	DB	DC	

Leaves age 40 $40,000 starting salary Retires age 65	**$8,367/year**	**$10,588/year** *plus* **$176,473** *principal*

15 years employment

Assumptions	DB	DC	

Leaves age 45	**$15,589/year**	**$16,355/year** *plus*

$45,000 starting salary Retires age 65		**$272,584** *principal*

20 years employment

Assumptions	DB	DC	

Leaves age 50 $55,000 starting salary Retires age 65	**$28,047/year**	**$24,470/year** *plus* **$407,827** *principal*

40 years employment

Assumptions DB DC

Leaves age 65 $25,000 starting salary Retires age 65	**$37,888/year**	**$21,781/year** *plus* **$363,013** *principal*

10 years employment

Assumptions DB DC

Leaves age 65 $60,000 starting salary Retires age 65	**$12,550/year**	**$3,701/year** *plus* **$61,678** *principal*