
CHAPTER 4

The Employer Case for Defined Benefit Pensions

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INTRODUCTION

The Great Recession and housing crisis destroyed trillions of dollars in household wealth after 2007. The precipitous decline of housing and stock market value has drastically reduced retirement income security in the United States. The Center for Retirement Research (CRR) at Boston College shows that the share of U.S. households who will not be able to maintain their standard of living in retirement has grown to over 50% (Munnell, Webb, & Golub-Sass 2009). And, the Employee Benefit Research Institute calculates that many households will not be able to compensate for this lack of retirement income security by simply working longer. It would take too long to recover the losses, jobs may not be available, and people's health may be failing in old age (VanDerhei & Copeland, 2011). Thus the current economic crisis has exposed the deep vulnerability of working Americans' retirement prospects.

Defined benefit (DB) pensions are a key source of retirement income security, since they offer guaranteed lifetime benefits. DB pensions, in combination with Social Security, typically provide for a solid middle class retirement, more so than the equivalent amounts of other savings, e.g., in 401(k) plans (Porell & Almeida, 2009; CRR, 2010). Households without DB pensions, but with other savings face a number of risks and hence economic costs that drastically reduce their retirement income security (Weller, 2010). The economic security associated with DB pensions explains their popularity in public opinion polls (Matthew Greenwald and Assoc., 2004; Matthew Greenwald and Assoc. & NIRS, 2009b).

The continuation of DB pensions as a key source of middle-class retirement income security will depend on employers' willingness to offer DB pensions. DB pensions offer key benefits to employers that cannot be found in other retirement benefits. At the same time, there can be drawbacks of DB pensions to employers, depending on how they are structured. Many of these drawbacks can be mitigated, as illustrated by the experiences of public sector pensions and multi-employer pensions in the private sector. Specifically, DB pensions tend to be more stable, implying greater attractiveness to employers, if they meet the following criteria: they are stand-alone entities that are not combined with employers' other business interests, they are pooled entities, where risks and costs are spread across

several employers, and there are regular contributions from employers, employees, or both, such that pension plans can take advantage of dollar cost averaging to avoid large funding swings.

This chapter will make the following points:¹ First, DB pensions enable employers to recruit qualified employees, especially those who will make a long-term commitment and who are invested in the future success of their employers, rather than those looking for short-term economic gains. Second, DB pensions are effective retention tools. They provide an incentive for employees to stay with an employer for more time than otherwise would be the case, since DB pensions defer some part of people's compensation into the future. Third, DB pensions can contribute to greater employee productivity due to better recruitment and longer tenure. Fourth, DB pensions are a highly efficient means of delivering benefits. DB pensions incorporate a number of insurance benefits to employees that do not exist with defined contribution (DC) plans. The cost of offering the same level of lifetime retirement income to employees is thus lower with DB pensions than with DC plans. Fifth, DB pensions work with the cyclical nature of employers' workforce management goals, while DC plans can work against them. Employees with DC plans are more likely to retire when economic times are good, savings are high, and employers' needs for experienced employees are greatest. In other words, DC plans can work against employers' goals of keeping talent on board during an economic boom. Similarly, in an economic downturn, employees with DC plans may find the value of their accounts impaired, and thus will try to stay on their job longer, just at the time when employers may be looking to reduce the size of their workforce. Sixth, DB pensions can remain an integral part of the retirement income landscape under the right circumstances. The experiences of private and public pension plans show that DB pensions are more stable if they are stand-alone entities with pooled investments that receive regular contributions from employers and employees.

1. DB PENSIONS: THE BASICS

DB pensions fall into three categories. The first is single-employer plans or "corporate plans," which cover the employees of one private sector employer and are part of the employer's operations. The second consists of plans that cover more than one employer in the private sector: multi-employer plans—also called Taft-Hartley—and multiple employer plans. The primary distinction is that Taft-Hartley plans are collectively-bargained and multiple employer plans are not. Both multi- and multiple employer plans are entities that are separate from a single employer and operate as stand-alone organizations. They cover the employees of several employers and are organized by industry, (such as construction), occupation (such as operating engineers), or both. Oversight of collectively bargained multi-employer plans is exercised by a joint labor-management board of trustees in which one half of the trustees come from the employer side and the other half from the employee side. Multiple employer plans are also overseen by a trustee or trustees, but there is no requirement of joint labor-management representation on the board. The third category includes public pension plans for the employees of state and local governments. Some public pension plans cover employees of only a single jurisdiction, e.g., a single city or town. The largest public pension plans cover employees from a wide range of public employers, for example, a state-wide teacher pension plan that covers employees in many school districts, or a state-wide municipal pension plan that includes local governments across the state. Plans like these function in a manner similar to multi- or multiple employer plans.

Pension plans are typically well regulated to ensure participants' benefit security. Both single and multi-/multiple employer plans in the private sector are governed by the Employee Retirement Income Security Act of 1974 (ERISA), which designates the U.S. Department of Labor (DOL) as the primary pension regulator, with some regulations, e.g., for investments and taxes, being also administered by the Securities and Exchange Commission (SEC) and the Internal Revenue Service. Public pension plans fall under state laws, which often can go further to protect workers than the private sector does. For example, public pension benefits in some jurisdictions enjoy legal protection against reductions that apply to both already-earned benefits and not-yet-earned benefits, while private sector employees are only protected against cuts of already earned retirement benefits.

About one-fifth of private sector employees and the overwhelming majority of public employees are potentially eligible to receive a future DB pension from their current employers (BLS, 2011; EBRI, 2011). Lifetime retirement benefits are generally based on a formula that considers the employee's years of service to the employer, age at retirement, and earnings history. Beneficiaries often have to work for at least five years in the private sector and possibly longer in the public sector before benefits become vested, i.e., before they earn a non-forfeitable and legally protected right to their benefits. Pension plans are "pre-funded" systems, i.e., benefits are financed by contributions made into the pension fund over the course of an employee's career, which grow as a result of investment earnings on accumulated assets. Pension contributions in the private sector are typically made by employers, but in the public sector a shared financing model dominates, with both employers and employees contributing. Employee contributions, where they exist, are typically made at a fixed percentage of their salary, regardless of whether the pension plan is underfunded or overfunded. Employers bear the risk if plans have too few assets to pay all promised benefits and more contributions are necessary. They do have some discretion, however, with regards to the timing and amount of contributions to their pension plans.

Traditionally, DB pensions have served as a form of deferred compensation, unlike other forms of retirement savings. Unlike employer contributions to a DC plan, which an employee can take with them when they leave an employer (provided they have met any vesting requirements), an employee must wait until retirement age to begin drawing benefits from a DB pension.

Since employers have some discretion in structuring DB pensions, many are designed with built-in incentives to retain skilled talent. Specifically, in final-pay plans that offer benefits based on an employee's pay at the end of a career, retirement benefits make up a smaller share of total compensation earlier in employees' careers, as compared with later (Cahill & Soto, 2003; Clark & Schieber, 2000; Johnson & Uccello, 2001).

However, some DB pensions do not defer compensation. So called "cash balance" pension plans are DB plans, but they resemble retirement savings plans in key aspects. A growing share of single employer pensions offered by private employers are cash balance plans (Weller, 2005a). Employers and/or employees contribute and employers again bear the risk of asset values falling too low to pay for promised benefits. Each worker in a cash balance plan has a notional (hypothetical) account designed to look like a DC plan, even though all funds are invested as one large pension pool. An employee's notional account is credited with an amount equal to a fixed share of a worker's earnings each year and the account balance increases annually at a pre-determined interest rate, the interest credit. Notional account balances can be taken and "rolled over" into other retirement plans when an employee switches jobs (Cahill & Soto, 2003; Clark & Schieber, 2000; Johnson & Uccello, 2001). If

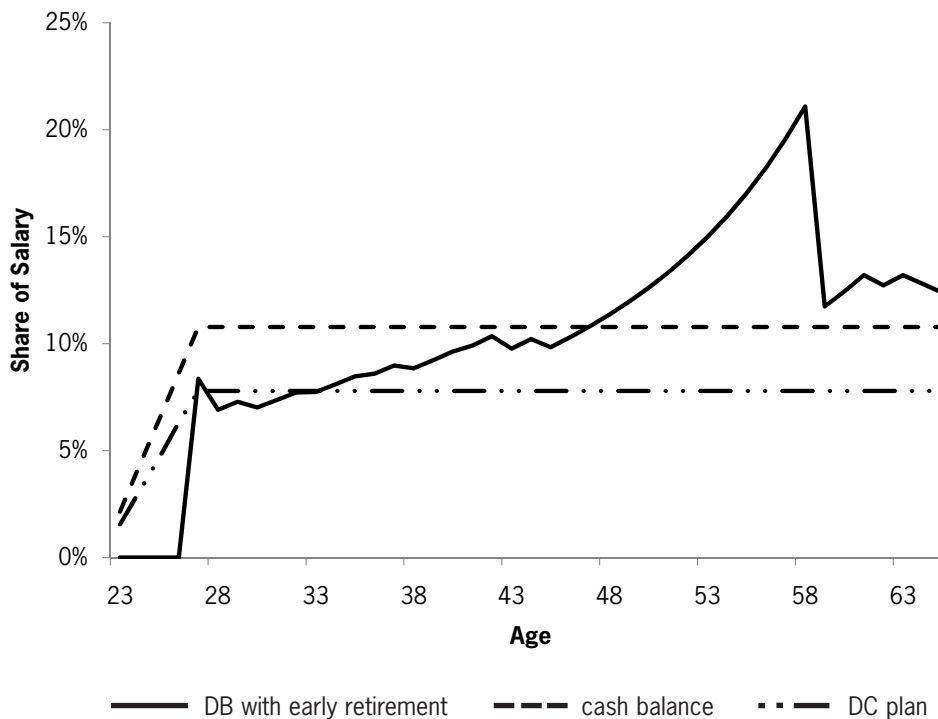
funds are not rolled over, the retirement benefit is determined by the employee's entire career earnings, not just those at the end of a career.

Figure 4.1 illustrates the differences between a plan design that defers compensation and those that do not. The annual benefit accruals under a typical final-pay pension plan, a cash balance pension plan, and a retirement savings plan are shown. The x-axis shows the employee's years of service and the y-axis shows the annual amount of retirement benefits relative to annual salary that the employee earns under each plan. Once the initial vesting requirement is met, employees earn an increasing amount of retirement benefits, relative to earnings, until they reach early retirement eligibility (in this example, after 35 years of service) in the final-pay plan, whereas in the other types of plans, benefit accrual is the same year-to-year, after vesting. Employees still earn additional benefits after the early retirement incentive is expired in the final-pay DB plan, but the annual accrual is less than during the years leading up to the early retirement age. These differences beg the question, which structure is preferable—an accelerating (then decelerating) benefit accrual, or a flat accrual pattern?

From the employer's perspective, a non-linear benefit accrual pattern may be advantageous. The acceleration in benefit accruals, which occurs later in the career, provides employees strong incentives to remain on the job. This enables the employer to recoup training costs incurred early in

Figure 4.1

Annual Wealth Changes for Employee Entering in 2011 Relative to Earnings under DB Plan, Cash Balance Plan, and DC Plan, Constant Normal Cost



Source: Weller (2011).

the employee's career and to take advantage of greater productivity that comes with experience, points to which we will later return. The early retirement incentive in this example may be a way for the employer to manage the size of the workforce at a future point, without having to resort to layoffs. By comparison, the flat benefit accruals of the cash balance and DC plans create no specific incentives to stay on with an employer or to depart. An employer may need to develop alternative strategies to achieve these objectives.

3. INDIVIDUAL RISK EXPOSURE IN DB PLANS AND DC PLANS

Employers bear a number of risks with DB pensions, which are shifted onto individuals in DC plans.² Individuals with DC plans need to make investment and withdrawal decisions for themselves. DC plans thus expose individuals to a number of key risks, which we label market, investment, and longevity risks.³ The fact that DB plans shield workers from these risks explains their popularity among employees and has significant implications for firm level productivity.

Market risk includes the risk of living through a prolonged trough in financial markets, such that the rates of return on individual savings are below long-term averages. Conversely somebody who lives through a prolonged market upswing such as from 1983 to 2000, will reap well above-average rates of return and thus above-average retirement income just because of the historical period during which they worked, saved, and invested. DB pensions promise a benefit that is independent of stock market performance during any given employee's lifetime, as long as employers keep their pension plans well supported, as we discuss further below. Employees with a DB pension hence will receive similar benefits, relative to their earnings, whether they had the good fortune to live and work through an up market or the bad luck of doing so through a prolonged down market on Wall Street. Employees with DC plans, by contrast, are exposed to market risk (Munnell & Sunden, 2004).

Investment risk is the risk of making unlucky or unwise decisions. Relatively large investments in employer stock in individuals' DC plans are a common example of investment risk (Munnell & Sunden, 2004). Investing retirement account assets in employer stock, as was the case for many employees at Enron, exposes both an employee's current and future economic wellbeing to the fate of one single employer. DB pensions avoid such investment risks, either because of federal regulations of private sector pensions under the Employee Retirement Income Security Act of 1974 (ERISA) or because of state rules and regulations for public sector DB pension plans, which mandate prudent investment practices such as portfolio diversification. For example, Weller and Wenger (2009a) show that public sector DB pensions were prudently managed before the financial crisis hit in 2007. That is, a diverse set of state regulations generally worked as intended to protect the retirement savings of millions of public employees from undue financial market risks.

Longevity risk is the risk of outliving one's savings. This risk is often discounted or misunderstood by employees saving for retirement. Often financial seminars will inform employees of their "average life expectancy," with employees concluding that if they save up enough money to last for the average life expectancy, they should be financially secure. But no individual is "average" — half of people will live *longer* than the average life expectancy, and risk outliving their savings. An individual would need to save enough to last for the "maximum" life expectancy to eliminate longevity risk. DB pensions can guarantee a lifetime stream of income more efficiently than a group of individuals, each

saving on their own, because pensions pool longevity risks. Unlike individuals, pensions can plan for the average life expectancy of their beneficiaries, since with a large enough pool, the life expectancy of a group will be quite predictable, whereas an individual's life expectancy is quite uncertain. DB pensions can insulate employees from fundamental risks, whereas DC plans tend to expose employees to these risks.⁴ The greater risk protection with DB pensions serves to explain a large part of their attractiveness to both employees and employers.

4. EMPLOYEE RECRUITMENT, RETENTION, AND PRODUCTIVITY

DB pensions can be highly effective recruitment and retention tools for employers (Friedberg & Owyang 2005; Gustman et al., 1994; Ippolito, 1997; Nalebluff & Zeckhauser, 1984) because they protect employees from key risks and because they defer compensation. The recruitment and retention effects may contribute to higher productivity, especially among skilled workers, when DB pensions are present than when they are absent.

Recruitment

The recruitment value of DB pensions lies in their intrinsic insurance functions. Individuals are generally not particularly fond of risk and prefer ways to reduce that risk, especially when it comes to something as substantial as retirement savings. Browning and Lusardi (1996) present a comprehensive overview of the fundamental economic argument why social insurance improves people's happiness ("utility" for economists), considering that people are risk averse.

Employees thus value the offer of some social insurance protections from their employers in the form of DB pensions. Employees generally value DB pensions more than DC plans. Ippolito (1997), for instance, finds that employees value pensions so highly that they would willingly forego higher wages for guaranteed retirement income, possibly reducing the costs of recruiting skilled employees. Watson and Wyatt (2005) reports that employees of firms with DB pensions had twice the probability of citing the retirement plan as an important factor in choosing their employer as employees at firms with only retirement savings plans; and that employees of firms with DB pensions placed a much greater importance on both attraction to and retention at their current employer than employees at firms with retirement savings plans. MetLife (2008) similarly finds that 72% of employees cited retirement benefits as an important factor in their loyalty to their employer. And, a survey of employers from Diversified Investment Advisors (2004) finds that 84% of DB pension sponsors—employers—believed that their DB pension has some impact on employee retention, with 31% stating that they thought this impact was major. The survey further finds that 58% of large employers (those with more than 25,000 employees) believed that their DB pension has a major impact on employee retention. Employers that offer pensions are able to attract sought-after employees because employees are attracted, in part, to employers with a DB pension.

Retention

The retention effect of DB pensions has been robustly documented in economic research as lower employee turnover (Allen, Clark, & McDermed, 1993; Even & MacPherson, 1996; Kotlikoff &

Wise, 1987; Munnell, Haverstick, & Sanzenbacher, 2006; Nyce, 2007). Allen, Clark, and McDermed (1993) offer evidence that employee tenure is greater at firms that offer DB pensions than at firms that do not. Even and MacPherson (1996) similarly conclude that firms without DB pensions experienced substantially higher turnover rates, ranging from an increase of about 20% in employee turnover to over 200%. The effect of DB pensions on employee turnover tends to be greater at smaller firms than at larger ones. And Munnell, Haverstick, and Sanzenbacher (2006) quantify the reduced attrition associated with DB pensions, suggesting that lower DB pension coverage and higher DC plan coverage beginning in the 1990s correlated with higher turnover rates at private sector employers. Offering a DB pension increases tenure with the employer by four years, according to their estimates, as compared to having no retirement system in place, and by 1.3 years compared to offering only a DC plan. The combination of a DB pension and DC plan increases tenure by 3.1 years, relative to only offering a DC plan.

Productivity

Employers with DB pensions may also be better able to attract desirable skilled employees due to self-selection. Ippolito (1997), for instance, focuses on the attraction effect of DB pensions and considers how employers use retirement plans to select employees interested in making a long-term commitment to their employers. Employees who delay gratification and who are less focused on immediate rewards are more attractive employees for employers that offer DB pensions. Nyce (2007) also finds that employees who are more likely to stick with a job also tend to be more likely to accept employment that offers a DB pension in the first place.

DB pensions, thus, may be superior for employers looking to attract employees who will share in the employer's mission. There is some tentative evidence comparing private sector workers, where DB pensions have become less prevalent, with public sector workers, where the vast majority is covered by DB pensions, that shows that public employees are more likely to value their work and that public employees are more likely to invest in their skills than their private sector counterparts. Houston (2000), for instance, shows that public employees are more likely to place a higher value on the intrinsic reward of work that is important and provides a feeling of accomplishment than are private employees. Wright (2001) similarly finds that public employees valued their work more than private sector employees, due to the inherent nature of public sector organizations that addressed complex social functions, supplying goods and services that cannot necessarily be bought and sold in a private market. Those who enter public service may place a higher value on carrying out acts for the good of their community, and the resulting internal satisfaction that these acts provide, than their private sector counterparts. It stands to reason that these employees value the work and its long-term rewards, including the deferred compensation from a DB pension, more than immediate financial rewards in the form of a salary. DB pensions may serve as a tool for employers to attract these employees by offering them their preferred compensation structure.

Moreover public employees tend to invest more in their skills than private sector employees, possibly because of the long-term commitment function of DB pensions. Because they reward long tenure, DB pensions may provide incentives for highly skilled employees like researchers, computer programmers, and lawyers, to stick with public service instead of seeking better-paid positions in the private sector. Public school teachers, for instance, who face strict certification requirements,

also tend to turn over less frequently than their private sector counterparts (Cannata, 2008; Guarino et al., 2006). DB pensions may serve as an incentive for employees to maintain and improve their skills because they know that a long tenure with one employer will be rewarded through deferred compensation.

Better recruitment of targeted employees, increased retention of skilled employees, and greater commitment to the employer translate into higher productivity with DB pensions than with other compensation forms. Dorsey (1995), for example, finds that some labor productivity gains can be attributed to DB pension coverage. More recently, Hall (2006) finds, based on an analysis of firms moving from DB pensions to DC plans, that those firms that dropped the DB pension experienced loss of productivity between 1995 and 2000, relative to firms that retained their DB pensions. This loss of productivity may be due to greater turnover after the switch to a DC plan, since more experienced and more skilled employees are leaving more quickly and are replaced with less experienced, less skilled employees, thus reducing average labor productivity growth. And Weller (forthcoming) shows that there is a substantial risk of lower teacher effectiveness following a switch from a DB pension to a DC plan or cash balance plan, based on the existing literature.

5. ECONOMIC EFFICIENCIES OF DB PENSIONS

DB pensions tend to be an efficient form of employee compensation. Employers can deliver retirement income security at a lower cost with DB pensions than with DC plans. This efficiency can further increase productivity since employers have to pay less to achieve the same level of economic security and thus happiness for their employees.

There are several aspects to the efficiency of DB pensions.

First, DB pensions achieve higher rates of return on investments than do DC plans. This is in part due to DB pensions' capacity to mitigate idiosyncratic risk through professional management and prudent investing practices, as discussed previously. Conservative estimates put the advantage at about 100 basis points per year (i.e., one percentage point in additional returns). This advantage, compounded over a career, translates into a 26% reduction in employer cost to provide a given level of retirement benefits (Almeida & Forna, 2008). Another reason for DB pensions' superior investment returns is that unlike DC plans, which are invested with a fixed retirement date in mind, pensions can invest for a much longer time horizon. Individuals saving for retirement are (correctly) advised to reduce investment risk towards the end of their career, however, this necessarily means foregoing potential investment earnings. DB pensions, by contrast, have a much longer investment horizon than individuals who face the biological reality of aging. Pensions that maintain a healthy balance of new entrants, middle aged workers, and retirees can ride out the ups and downs of financial markets, avoiding selling assets when markets are distressed, which is sometimes a necessity for individuals. This superior ability to absorb market risk has a material effect, lowering employer costs by about 5% over a career (Ibid.).⁵

Second, because of DB pensions' better ability to manage longevity risk as compared with DC plans, employer costs are reduced. Individuals attempting to "self-insure" against longevity risks must accumulate far more assets than a DB pension would, essentially because the employee must plan for the "maximum" life expectancy, while the DB pension needs only to plan for the average life

expectancy. This is an expensive proposition. Employer costs under a DB pension are 15% lower thanks to longevity risk pooling (Ibid.). The benefit security is thus greater per dollar invested in a DB pension than in DC plans.

Third, the actual retirement decision offers additional efficiencies to employers with DB pensions. DB pensions can encourage “efficient retirement,” such that employees withdraw from the labor force at the optimal time, when their productivity decreases. Lazear (1983), for instance, argues that DB pensions can function similar to severance pay in encouraging efficient retirement as employees age and their productivity starts to level off or even to decrease. And, Nalebluff and Zeckhauser (1984) argue that the features of most DB pensions can be designed to facilitate employees’ retirement decisions.

The evidence suggests that efficient retirement indeed works as DB pensions incentivize crucial employees—those committed to the success of the organization—to stay with the organization. The retirement decision under a DB pension positively interacts with other advantages of DB pensions. Employees tend to feel more committed to their employer when a DB pension is present and those employees who feel particularly committed to their employer in the presence of a DB pension tend to retire about two years later than employees who are less committed (Luchak, Pohler & Gellatly, 2008). Employees who care about the success of the organization, are hence more likely to contribute productively to that employer, when covered by a DB pension.

Fourth, DB pensions reduce the pro-cyclical bias towards retirement—retiring during the good times when employers need employees the most and sticking around during the bad times when employers need employees the least. This bias is evident from retirement decisions during financial market swings (Weller, 2006; Weller & Wenger, 2009b). Employees with DB pensions will make their retirement decisions based on a number of factors, including the level of benefits that they have earned, since that will be a major factor in their post-retirement well-being. Because pensions are pre-funded, with assets held in a trust for the sole benefit of employees and retirees, DB pension benefits are independent of employers’ immediate financial fortunes in the private sector and even more so in the public sector, where benefits are often constitutionally protected. The number of people retiring will not vary all that much between recessions and recoveries, if employees are covered by a DB pension.

Retirements will vary substantially when employees are covered by DC plans. Employees have a greater incentive to retire during an economic boom period, because their DC plans are flush. But those are also exactly the times when employers will need skilled employees most since labor markets tend to be strong as well (Weller & Wenger, 2009b). The opposite holds true in recessions, when employers with retirement savings plans encounter a phenomenon known as job lock, whereby employees become more likely to stay on the job as a recession unfolds. This is because recession brings with it a financial market decline that reduces the value of DC plan assets. Employees may hence decide to work longer to make up for these losses. But, employees who want to work longer in this instance will have to try to stay with their existing employer since unemployment rates also go up in a recession. As a result, when employers that offer DC plans start looking to reduce the size of their workforce, they may be more likely to have to resort to layoffs, as compared with employers that offer DB pensions.

This problem of pro-cyclical retirement timing is further exacerbated by employers reducing their contributions to their employees’ retirement savings plans during an economic downturn

(Munnell & Sunden, 2004). What employers may view as a necessary cost-savings measure, can exacerbate job lock.

Employees thus have more incentives to stay with an employer as economic times worsen, if their primary benefits come in the form of DC plans. In a 2008 survey of recent retirees, 76% indeed reported that their ability to afford retirement was an extremely or very important factor in their decision to retire, and 81% of those with a DB pension reported that the DB benefit itself was either extremely or very important in determining retirement affordability (Helman et al., 2008). DC plans can thus exacerbate labor market swings, while DB pensions tend to generate more stable employment relations over the course of the business cycle. Employers may consequently incur larger employment related costs to manage their workforce and thus reduced productivity with retirement savings plans than is the case with DB pensions.

6. FACILITATING EMPLOYER SUPPORT FOR DB PENSIONS

Employers in the private sector have been cutting back on DB pensions even though they can offer a number of advantages to both employers and employees. This contrasts with a more stable situation under multi-employer and public employee DB pension plans. Coverage by multi-employer pension plans has been much more stable than that by single employer plans in recent decades, although substantially fewer employees are covered by multi-employer plans than by single employer plans (Almeida, 2007). Also, public employers (state and local governments) have stuck with their DB pensions, even as they faced growing financial demands from their pension plans and revenue shortfalls due to the economic crises of 2001 and 2007-2009. Governmental employers have dealt with their financial challenges in many cases by modifying benefits. Thirty-nine states made changes to their pension plans between 2001 and 2010. However, only one state, Alaska, switched from a DB pension to a retirement savings plan (Pew, 2011). All other states introduced a combination of higher employee and employer contributions and slower benefit growth, but generally maintained DB pensions as the only or the primary retirement benefit (see Pew, 2011; Boivie & Weller, forthcoming; and Wojcik, 2008 for more details).

The contrasting experience of single employer DB pension plans in the private sector on the one hand and private sector, multi-employer DB plans and public sector DB plans on the other, suggests that there are features of these latter plans that make them more attractive to employers than single employer plans.

Three features stand out in this comparison that can explain the difference in the trends we observe and thus inform future DB pension design. These features are: organizations that are separate from other employer operations, regular contributions from employers and employees, and economies of scale and scope that stem from pooling risks and investments.

Employer surveys confirm the reasons for employers abandoning single employer DB pensions. As new legal changes for private sector pensions were discussed in the early 2000s, employers indicated that by far their primary concern—with 33% of employers listing it as their main concern—was the possible cost volatility associated with the legal changes (Hewitt, 2003). Munnell et al. (2006) similarly argue that unpredictable changes and risk exposure were a driving force for economically healthy employers to abandon their DB pensions. The proposed legal changes that

ultimately became law with the Pension Protection Act of 2003 introduced greater volatility to valuation of pension plan assets and liabilities and thus greater volatility to the amount that an employer would have to contribute from year to year, at least for employers who were not used to making regular contributions to their DB pension plans (Weller, 2005b). Regular contributions to stand-alone entities lower this uncertainty since the chance of underfunding and catch-up contributions is mitigated.

The desire to cut benefit costs in the face of increasing global competition and rising health care expenditures also contributed to the decline of DB pensions (Hewitt, 2003; Munnell et al., 2006). Hewitt (2003) finds that 19% of employers listed overall cost as their main concern. The experience of public DB pensions, though, has shown that employers can handle these competing challenges without abandoning DB pensions.

Other often-cited reasons, especially employee mobility, play a minor role in employers' concerns over DB pensions. Hewitt (2003) finds that only 2% of employers list employee mobility and 6% lack of employee appreciation as their main concern with their DB pensions.

DB pensions thus should be more stable in an environment with high economic efficiency—to reduce costs—and predictable contributions that are ideally not comingled with other operations of the employer.

Stand-Alone Entities

One of the common characteristics of private sector multi-employer plans and most public pension plans is that they are entities separate from the employer's other operations.⁶ While it is the case for every pension plan that investments are held in a trust separate from other employer funds, the plan oversight structure can vary greatly. When it comes to single-employer plans, the employer "wears two hats." As plan trustee, the employer is as a fiduciary of the plan, meaning that they owe a duty of loyalty to plan participants and decisions must be guided by the best interest of the plan's beneficiaries. As the plan sponsor, the employer performs "settlor" functions—adopting the plan, changing its provisions, and funding the plan. Sometimes the line between these two functions can become murky. By contrast, a governance structure that is independent of a single employer or individual, such as the joint labor-management trustee model that prevails among multi-employer plans, or diverse boards drawn from various stakeholders that can be found in public pension plans, means that pension trustees and pension plan administrators can focus on prudently managing their investments to ensure benefit income security, without having to simultaneously worry about an individual employer's finances. Put differently, employers do not have to worry about the management of their pension plan investments and the administration of contributions and benefits, but leave those to a separate organization—the pension plan. Employers and pension plans can each manage their own responsibilities and not be distracted by the demands of the other.

Regular Contributions

Both multi-employer and public pension plans tend to receive regular contributions. These are predictable contributions to DB pension plans paid on a monthly, quarterly, or semi-annual basis, either calculated as a fixed dollar amount per hour worked, or as constant share of employees'

salaries. With multi-employer plans, contributions are made by employers, pursuant to collective bargaining agreements (Almeida, 2007). And in the public sector, employees generally contribute a fixed share of their salary to state and local government DB plans, with employer contributions often (though not always) varying year-by-year according to the economic needs of the plan. In 2004, for workers covered by Social Security, the median employer contribution to public plans was 7% of salary while employees contributed an additional 5% of salary (Munnell & Soto, 2007).

Contributions to private sector single-employer plans, by contrast, can be quite volatile. By law, employers contribute to their pension plans depending on two factors: how well funded the DB pension is, and the benefits that have been earned in that year by current employees. If a plan is “well funded,” meaning that the assets in the pension trust are sufficient to cover the current and future costs of all benefits, employers may not be required to contribute anything to the pension. Conversely, if a plan is “poorly funded,” with assets insufficient to cover the cost of all future benefits, the employer may be required to contribute substantial sums. ERISA and the Internal Revenue Code regulate the way employers have to calculate the amount that they need to contribute to their single-employer pension plans. These regulations were last updated with the Pension Protection Act of 2006, which created greater volatility in the amount that employers have to contribute (Weller, 2005b; Weller & Baker, 2005), but which did not require regular employer contributions.

Regular contributions offer several advantages to employers, even if they are made by employees.⁷ First, regular contributions are predictable. Employers know what they have to pay when they participate in a private sector multi-employer plan and they know what their pension plan will receive on a regular basis in the case of state and local government DB pension plans. Second, regular contributions allow pension plans to take advantage of dollar cost averaging, an investment process that works as follows. The same amount of contributions buys a lot of comparatively cheap investments in the middle of a crisis, while it pays more dearly for investments during a market upswing. The result is an average price that pension plans pay for their investments over a number of months, years, and even decades. This average price for investments is below the high price for investments during a financial market peak and above the price for investments during a financial market trough. A drop from the market peak thus hurts pension plans less than if they had not used dollar cost averaging; and DB pension plans that receive regular contributions can take advantage of an upswing from a market trough. Dollar cost averaging serves as an insurance against market swings for investors. Third, regular contributions lower the chance of pension plan underfunding. DB pension plans that receive regular contributions have to rely less on the investment performance of their assets to pay for promised benefits. A sharp drop in financial markets as occurred in 2000–2001 and 2008–2009 will thus have less of an effect than in a case where DB pension plans do not receive regular contributions.

Economies of Scale

Multi-employer plans and public pension plans achieve substantial economies of scale that most individual employer plans cannot achieve. Because of their large asset pools, multi-employer and public sector DB pension plans may be able to drive down administrative costs and reduce asset management and other fees (Council of Institutional Investors, 2006; Munnell & Soto, 2007; Weller

and Jenkins, 2007). Furthermore, investment decisions in multi-employer and public sector DB pensions are made by professional investment managers whose activities are overseen by trustees. DB pension plan assets are broadly diversified and managers follow a long-term investment strategy. Weller and Wenger (2009) find, for instance, that state and local plans exercise a great deal of prudence, tending to rebalance their assets regularly in response to large price changes. Also, public sector plans' holdings of higher-risk/higher-return assets increases when these plans have higher funding levels, thereby indicating that plans do not "chase return" in response to lower funding levels (Weller & Wenger, 2009), and public sector plans' holdings of equities is smaller when demands on employers in the form of higher contributions increase.

Another advantage of larger DB plans is that they can take advantage of broader diversification strategies. In recent years, some DB plans have allocated a small percentage of their holdings to include so-called "alternative" investments such as private equities, venture capital, and hedge funds. These investments can help to improve the returns and/or reduce the overall risk of a plan's portfolio by introducing assets whose returns are uncorrelated (Flynn and Lum, 2007; Seco, 2005; Phillips & Surz, 2003; Indjic & Partners, 2002; Watson Wyatt, 2008).

Policy Applications

The knowledge that stand-alone entities, regular contributions, and pooled resources may make DB pensions more attractive to employers has influenced the development of policy proposals. Two examples are worth highlighting here. One is the Benefit Platform for Life Security proposal by the ERISA Industry Council (ERIC), an employer association, envisioned for the private sector. The other is the possibility of opening existing public sector pensions to other employee groups.⁸

ERIC's Marc Ugoretz (2007) proposes the 'Guaranteed DB Plan' as part of a broader benefits "platform." This would be a DB pension option offered to employees without retirement benefits through third party, private sector, benefit providers. An employer would select a service provider or Benefits Administrator that would offer a standardized plan to its workforce. Employers, on behalf of their employees, would regularly and voluntarily contribute to the plan. Employees would receive a guaranteed monthly benefit upon retirement. Employees would not be permitted to access their savings before retirement, but assets would be portable between jobs as long as the employee stays with the same Benefits Administrator. Benefits would be calculated as a flat percentage of pay that increases each year at a predetermined interest rate. Upon retirement, the employee's accumulated savings would be converted to a monthly annuity.

The benefit formula of the Guaranteed DB Plan is thus akin to a cash balance plan, rather than a traditional final-pay DB pension. Employers may hence be able to access the efficiencies of DB pensions and may benefit from the recruitment benefits of DB pensions, but may not enjoy the advantages of DB pensions as retention tool since there is no deferred compensation (Weller, forthcoming).

Another possibility to broaden DB pension coverage may be the expansion of existing public sector DB pensions to private sector employees. Although current regulations create hurdles to "mixing" public and private sector employees in a single plan, the potential benefits of such an approach can be seen in the experience of the Municipal Employees Retirement System (MERS) of Michigan. MERS is a public retirement system that serves municipalities across the state. Recently, access to

MERS has been expanded to employees of tribal governments in Michigan, which previously had not offered DB pensions to their workforces (MERS, 2010). Extending this model further could include public pension systems creating a separate, distinct DB pension plan for private-sector employers that are too small to deal with the costs and administrative complexities of offering a pension on their own. The public retirement system would administer the plan, collecting contributions, investing assets, and paying out benefits, often with the involvement of private financial service providers. This would enable small businesses to access the economies of scale that come with participation in a multiple employer plan and offer high quality benefits to their employees at a modest cost. As any plan covering private sector employees, the pension would be regulated under ERISA.

Like the ERIC proposal, this type of public-private partnership approach would leverage the strengths of stand-alone entities, with the possibility of regular contributions from employers, and with the economic advantages of economies of scale. The benefit formula could be a traditional DB pension formula, thereby offering employers all of the typical benefits associated with DB pensions: recruitment, retention, and efficiency.

7. CONCLUSION

We review the evidence on the benefits of DB pensions for employers in this chapter. Employers can use DB pensions to their advantage to recruit skilled employees that are committed to the long-term success of the organization, they can more easily retain skilled employees with DB pensions than is the case with alternative benefits, and they can deliver retirement benefits more efficiently with DB pensions, thus saving money and potentially increasing productivity.

DB pensions tend to fare better under certain circumstances than others. The evidence for U.S. employers in the private and public sector suggests that DB pensions are more stable if they operate as stand-alone entities that are separate from the employers' other operations, receive regular, stable contributions from the employees, employers, or both, and if they are large enough to take advantage of the benefits of economies of scale in their administration and investments.

This evidence also suggests that the promotion of stable DB pensions may not necessarily require large policy changes. But, the examples of the private and public sector where DB pensions are comparatively stable, specifically multi-employer plans and state and local government plans, indicate that the promotion of stable DB pensions requires some coordination mechanism to bring together several employers to implement the three characteristics we highlighted—stand-alone entities, regular contributions, and economies of scale. We present two proposals—one from an industry association and one from a state-wide municipal DB pension plan—to show where the coordination of employers could come from. It could either be through public seed funding of stand-alone DB pension plans or through the expansion of already existing public sector DB pensions to private sector employers and their employees.

The lessons from our discussion are thus twofold. First, DB pensions offer employers a number of attractive advantages. Second, employers could enjoy these advantages at relatively low costs, given the right circumstances. It would not require massive policy changes at the federal or the state level to start creating these circumstances.

* * *

Endnotes

¹ Our chapter primarily focuses on private sector pensions. We will compare DB pensions to defined contribution (DC) plans. Different account types are prevalent in different sectors, specifically 401(k) plans are common among private sector employers, while 403(b) plans are more common among public employers.

² See Weller (2010) for a survey of the literature and an analysis of individual responses to increased risk exposure, when DB pensions are not present.

³ The greater risk exposure under DC plans than under DB plans is intentional. The economic logic originally went that more risk poses a cost to individuals, who generally do not like risk. Individuals should consequently save more to compensate for the greater risk (see Browning and Lusardi, 1996 for a summary of the related literature). More recent research—behavioral economics—has shown that this logic has its limits since it makes unrealistic behavioral assumptions about individual decisions (see DellaVigna, 2009 for a review of the relevant literature). It assumes that individuals fully understand complex risks, completely understand how to protect themselves from these risks, and will follow this knowledge. Humans generally do not have the full appreciation of all of the complexities and even when they do, they do not necessarily act on that knowledge. Greater risk exposure has resulted in more savings, but not enough to compensate for the full increase in individual risk exposure (Weller, 2010).

⁴ Cash balance plans theoretically offer employees insurance protections similar to those of traditional DB pensions. Most cash balance plans in the private sector, though, offer employees the option to get all of their retirement money up front upon retirement in the form of lump sum distribution (Weller, 2005a). This can expose individuals again to potential market, investment, and longevity risks.

⁵ Cash balance DB pensions may need to hold more cash to accommodate employee withdrawals due to increased benefit portability, which lowers the average rate of return.

⁶ See Almeida (2007) for a detailed discussion of multi-employer plans and Weller (2008) for details of public pension plans.

⁷ Economists generally treat all contributions as being borne by employees, regardless of who actually makes the contribution.

⁸ Weller and Helburn (2010) summarize a range of proposals, including these two, to show the possibilities for state governments to increase retirement income security for private sector employees.

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