The Oklahoma State Worker Pension Plan

If It Ain't Broke, Don't Break It

Testimony • By **Stephen Herzenberg** and **Ross Eisenbrey** • February 14, 2014

Summary. If it ain't broke, don't fix it, goes the saying. But in a rapidly moving effort to radically restructure Oklahoma pensions for state employees, the more apt phrase is "if it ain't broke, don't break it."

Oklahoma policymakers appear set on taking a financially sound, cost-effective state pension plan that provides modest middle-class retirement security for Oklahoma nurses, food safety inspectors, cooperative extension agents, and other public servants, and replacing it with a 401(k)-style retirement savings plan increasingly recognized in the private sector as an abject failure.

This shift, possibly on a fast track and without basic due diligence – such as an actuarial study of the taxpayer costs and impact on retirement security of closing the existing Oklahoma Public Employee Retirement System (OPERS) – would:

- Increase the cost of paying pension obligations to current employees and retirees in OPERS by potentially billions of dollars;
- Shift new workers into retirement savings plans that are less efficient (cost-effective) than the current OPERS plan, requiring as much as 85% higher (employee plus taxpayer) contributions to deliver a given level of retirement benefit;
- Move new workers into 401(k)-style retirement savings plans at precisely the time when a chorus of observers have recognized that these plans have failed to deliver retirement security in the private sector; and
- Increase employee turnover and the associated costs and negative impact on public service quality. The current pension plan offsets low public sector salaries, leading mission-driven public servants to remain in their positions for a full career. This critical retention tool would be eliminated by a transition to 401(k)-style retirement savings plans.

This brief relies in part on an earlier brief released last November 20, which contains more detail and more complete references.[2]

Background. Oklahoma Governor Mary Fallin in her "State of the State Address" last week signaled her support for shifting new state employees into a 401(k)-style "defined contribution" plan. Then on Monday, February 10, the State Pension Committee approved Senate Bill 2120, which would make a new 401(k)-style plan effective for all new employees hired starting November 1, 2015.[3] The proposal would require employees to contribute a minimum of 3% and up to 7% to their 401 (k)-style individual retirement savings account, which would then be matched by their employer. This proposal has been advanced without any study of its impacts – on taxpayers, on employees, on the state as an employer. (Since the proposal under consideration currently concerns OPERS, we focus our discussion on that plan. Most of the arguments here would also apply to proposals to close Oklahoma's other defined benefit pensions.)

The Oklahoma Public Employee Retirement System. OPERS, as with other "defined benefit" pensions, provides retired state (and county) workers with a modest pension (an average annual benefit of about $16,000 for state employees) tied to employees' final average salary (now calculated over five years for new employees) and years of service (most employees receive a benefit equal to 2% of final average salary times years of service). OPERS is currently 81.6% funded, above the 80% threshold that many actuaries consider financially healthy.[4] As elaborated in our earlier brief, OPERS now has the characteristics of a best-practice public pension plan, including because it has made (more than) the Annual Required Contribution (ARC) in the last two years that pension actuaries deem necessary.

Also as elaborated in our earlier brief, Oklahoma pension plans as a group made substantial changes after each of the financial market downturns since 2000, thanks to farsighted legislative action. Thus, Oklahoma's pension funds, including OPERS, are now as well funded as they were in 2001, whereas typical public pension funds, most of which started off better funded than Oklahoma, now have a 25% lower funded ratio than in 2001 (for details and sources, see our earlier brief).

OPERS – and other Oklahoma pension funds – could be likened to a car that has had a couple of collisions but has now been repaired, washed and waxed, and is ready to hit the road again. Is that the moment when it makes sense to trade in these plans for a clunker?

Defined Contribution Retirement Savings. Rather than guaranteeing a specific annual pension payment, defined contribution retirement savings plans guarantee only specific levels of employer and employee contributions. Workers usually make their own choices about how to invest these contributions (usually from a specified set of options selected by the employer).

From the perspective of taxpayers – leaving aside, for the moment, the impact on public employees – the defined contribution approach to retirement savings has two fundamental flaws, each one independently fatal and sufficient to warrant policymakers retaining the current OPERS defined benefit pension.

The High Cost of Closing a Defined-Benefit Pension. A large number of actuarial and other research studies document that closing a defined-benefit pension and putting all new hires into 401(k) -style retirement savings plan has a substantial transition cost. Investment returns on the assets of the closed pension plans fall as these plans wind down. This erosion happens because, once the existing pensions are closed to new employees, they lack a balance between young, mid-career, and retired workers. Pension managers can no longer invest for the long term and also have to keep a larger share of pension assets in liquid form, ready to convert into pension checks. A more conservative investment strategy and lower investment returns result. If investment returns pay for less of existing pension plan obligations, taxpayers have to pay more.

The actuarial studies find an erosion of investment returns even if employer contributions to pay down an unfunded liability continue to be spread across the entire workforce, including new employees not in the defined benefit plan.[5] For example, Pennsylvania's Governor last year proposed to close the state's two defined benefit plans and move new hires into 401(k)-style individual accounts, exactly as proposed for OPERS. Pennsylvania also proposed spreading employer contributions to pay off the unfunded liability across all employees, including new hires who would not be in the defined benefit plans. Even so, three actuaries concluded that closing the state's defined benefit pensions to new employees would lower investment returns, leading to a $40 billion increase in unfunded liabilities.[6] The logic behind this result is that the time horizon for investing pension plan assets is limited by the shrinking period over which the closed pension plan members retire and then pass away.

Less Cost-Effective Pensions. Research and actual experience show that, for several reasons, defined contribution pensions are much less "efficient" (cost-effective) than defined benefit pensions.[7]

- Defined contribution pensions deliver lower investment returns, partly because individuals making investment choices do not match the returns of investment experts who manage defined benefit pooled funds and partly because individuals need to invest more conservatively as they approach retirement. By contrast, pension plans that retain a mix of young, mid-career, and older workers and retirees can maintain a diversified portfolio and invest for the long term
- Defined-contribution plans have higher administrative costs because of the need to manage individual accounts and higher marketing (or educational) costs incurred to educate plan participants about their investment options.
- DC plans have higher financial management and trading fees.
- DC plans do not pool longevity risk. When individuals convert their accumulated savings into an annuity – a fixed payment until they die – their annuity payment is lower because the provider of the annuity knows an individual is more likely to purchase an annuity if they are in good health and have a longer-than-average life expectancy.[8] Since defined benefit plans do pool longevity risk across tens of thousands of plan members, they can base annuity payments on the *average* life expectancy of the population.

Two recent National Institute on Retirement Security studies gauge the combined impact of all of these DC plan inefficiencies.[9] These two studies conclude that defined contribution retirement plans cost 45% to 85% more in employee plus taxpayer contributions to deliver the same level of retirement security. An Economic Policy Institute/Retirement USA report independently came to a similar conclusion.[10]

The Failed 401(k) Revolution. Oklahoma is at risk of rushing toward 401(k) style pensions at precisely the moment when many pension experts and business periodicals are having second thoughts about 401(k)s. The context for these second thoughts is increasing awareness of an emerging retirement security crisis in America. Even though many seniors still benefit from the 1960s to 1980s period when most private sector jobs came with a defined benefit pension, nearly half (48%) of the elderly population in America is "economically vulnerable." (Economically vulnerable is defined as having an income that is less than two times the "supplemental poverty threshold," a poverty measure more comprehensive than the traditional federal poverty line.[11])

The rise of economic vulnerability among seniors has coincided with the switch from DB to DC plans. Since 1981, the share of private workers with defined benefit pensions has dropped from an estimated 57% to 22%.[12] Meanwhile, the share of private-sector employees with 401(k)-type savings accounts –zero before 1980 because they didn't exist – reached 50% by 2011. (In 2011, an estimated 41% of private employees had neither a DC or DB retirement plan.) Half of American households age 55-64 (when retirement savings peak) who have a retirement savings account have $12,000 or less saved.[13] The low savings in many 401(k) retirement plans, combined with low 401(k) returns, high costs, and the financial market risk to which 401(k)s expose individuals and families have led to the widespread criticism of 401 (k)s (Box 1).

Box 1. Recent Media Reports on 401(k) Retirement Savings Plans

Just how good are 401(k) retirement plans? A number of recent news and magazine articles recognize that they are a bad deal for workers, providing less retirement security than defined benefit pension plans. Here are some recent quotes from business magazines and other media sources that highlight how 401(k) plans are less cost effective than pension plans and produce less retirement security for working Americans.

The 401(k) – America's big, troubled, $4 trillion retirement solution – was an accident

Quartz, February 3, 2014 *(online at* **http://qz.com/173237/the-401k-americas-big-troubled-4-trillion-retirement-solution-was-an-accident/**)

"The result [of 401(k)s] besides providing an opportunity for businesses to avoid promising a regular retirement pension, was to put more of the onus on workers to save. Meanwhile, the fees charged by the private wealth managers of these tax-advantaged retirement funds has eaten into workers' savings; an average two-earner family can pay $155,000, or nearly a third of their investment returns. For these reasons, another official involved in the creation of the [401(k)] law interviewed by *Businessweek* said "there are certainly times when I think it may have been a terrible mistake."

Pension Plans Beat 401(k) Savers Silly — Here's Why
Forbes, June 4, 2013 (online at
http://www.forbes.com/sites/mitchelltuchman/2013/06/04/pension-plans-beat-401k-savers-silly-heres-why/)

"Towers Watson, the global human resources consultant, found that pension-style plans beat 401(k)-style offerings by nearly 3 percentage points in 2011, the latest study year. Pensions made investment returns of 2.74% while defined contribution plans lost money, banking -0.22%.

It's no fluke. [Defined benefit] [p]ension plans often beat 401(k) plans. … Part of the reason is mutual fund fees. Mutual funds in the plans studied had weighted average expenses of 65 basis points [0.65%] in 2011… "

Retirement Gamble: Frontline's Powerful Case for Taking Control of your Financial Future
Time Magazine, April 23, 2013 (online at **http://business.time.com/2013/04/23/retirement-gamble-how-fees-and-poor-results-destroyed-your-401k/#ixzz2Ws85q2E6**)

"Traditional pensions have been supplanted by 401(k) plans, which have proved to be massively ineffective as a primary source of retirement security. Billions of dollars in savings have leaked out of these plans over the years and trillions were wiped away in the market collapses of 2000 and 2008."

Abolish the 401(k): The real crisis facing America's aging society is not Social Security, but private retirement plans
Salon.com, April 4, 2013 (online at **http://www.salon.com/2013/04/04/abolish_the_401k/**)

"But the risks, including risks from poor investments and the chance that you will retire during a stock market downturn, fall entirely on the individual. Even worse, many working-class and middle-class Americans with 401Ks are stealthily fleeced by money managers, who charge high and often difficult-to-find fees for allocating retirement money among stocks, bonds and other assets."

The Greatest Retirement Crisis In American History
Forbes, March 20, 2013 (online at **http://www.salon.com/2013/04/04/abolish_the_401k/**)

"Americans also know the great 401k experiment of the past 30 years has been a disaster. It is now apparent that 401ks will not provide the retirement security promised to workers. As a former mutual fund legal counsel, when I recall some of the outrageous sales materials the industry came up with to peddle funds to workers, particularly in the 1980s, it's almost laughable—if the results weren't so tragic."

What Will Replace the 401(k)?
Time Magazine, March 21, 2012 (online at **http://business.time.com/2012/03/21/what-will-replace-the-401k/#ixzz2Ws9a3Kir**)

"With little or no return for more than a decade—and just as baby boomers begin to retire—the savings crisis has pushed us to new levels of despair. More than half the population has less than $25,000 saved for retirement, according to the Employee Benefits Research Institute."

Retirement overhaul: 401(k)s may not be the answer now
USA Today, October 23, 2009 (online at **http://usatoday30.usatoday.com/money/perfi/retirement/2009-10-19-401k-savings-retirement_N.htm**)

> "Now, we're in a different world," says Ted Benna, a retirement consultant who created the first 401(k) plan in 1980 and is semi-retired. "How are we going to move forward from here? It will be interesting to see. And I am not going to lose any sleep if 401(k) doesn't survive."

Weakening Oklahoma's Ability to Retain Experienced Public Servants. In her State of the State Address, Governor Fallin cited a new remuneration report[14] conducted by Hay Consulting for the State of Oklahoma Compensation Committee.[15] The report found that Oklahoma average and median salaries are well below (21.7% and 18.2%, respectively) those at a comparison Oklahoma private sector employer group constructed by Hay.[16] Taking into account benefits, total remuneration (compensation) is 7.4% lower in Oklahoma state government than at the comparison private employer group.[17]

These findings accord closely with national public vs. private compensation estimates generated using a different (and more transparent) methodology by Rutgers economist Jeff Keefe. Keefe found that state workers across the country earn compensation (wages plus benefits) 7.6% less than comparable private sector workers who have similar levels of education, experience, and other attributes that impact wages.[18] The public-sector compensation gaps rises to 25% for workers with a bachelor's degree (and the gap shrinks and reverses for the least educated groups).[19]

The Hay and Keefe studies also agree that the public sector pays more of compensation in the form of benefits (and less in wages and salaries). While Governor Fallin considers Oklahoma's high benefit payments "lopsided," it makes sense for government employers to provide defined benefit pensions that are highly valued by the kind of career-oriented workers they hope to attract and retain, especially since government entities (unlike some private-sector employers) are well suited to taking on long-term pension liabilities.

Governor Fallin said in her State of the State speech that a switch to 401(k)-style pensions "allows flexibility for future public employees to take the money they have accrued with them if they change careers," and argues that this will aid the state in recruitment. We think it is more likely that 401(k)s would exacerbate turnover in Oklahoma state government. The summary of the remuneration study points out (slide 3) that turnover is already a problem in Oklahoma state government: "Several years of no general funding for across-the-board raises, coupled with increased turnover, has [sic] caused concerns to the Executive and Legislative branch leadership, as well as the Employee Association, regarding compensation." Such turnover has a high economic cost and also erodes the quality of public services. Defined benefit pensions are currently Oklahoma's most powerful tool for retaining educated and experienced civil servants despite the significant sacrifices they make by accepting lower salaries. Giving up this retention tool could make turnover in Oklahoma state government a bigger problem, including in middle management and professional positions typically held by career civil servants.

A Misguided Step Backwards

In her State of the State address, Governor Fallin suggested that a switch to 401(k) retirement plans would (a) stabilize Oklahoma pensions financially, (b) eliminate "an outdated, mid-20th century pension system," and (c) allow the state government to catch up to the private sector. How do these claims stand up against the research reviewed in this brief?

(a) A switch to 401(k)'s would destabilize Oklahoma's pensions financially, potentially saddling taxpayers with billions of dollars in additional debt.

(b) Oklahoma's defined-benefit pensions are actually the norm for the U.S. public sector – with early four out of five (78%) state and local government employees in the United States having defined benefit pensions.[20] Defined benefit pensions well match the stability of government and the need to give underpaid middle- and upper-level public employees an incentive to accept a career of economic sacrifice.

(c) Why would Oklahoma want to "catch up" with a private sector trend that is threatening middle class retirement security? The Governor implies that the private sector shift away from 401(k)s had something to do with employee choice, resulting because the defined benefit pension model "didn't appeal to a more mobile workforce in today's modern economy." In fact, private employees did not "choose" to switch from middle-class defined-benefit pensions to 401(k) accounts to which most employers contribute little or nothing. This switch was driven by employers' desire to cut costs and offload most of their responsibility for retirement plans.

In sum, Oklahoma should not try to catch up with a private sector retirement security model that would impose a large transition cost on taxpayers; result in inefficient retirement plans that give Wall Street managers of 401(k) accounts more money but Main Street, Oklahomans less money in their retirement; and leave too many workers with little or nothing in retirement savings.

Endnotes

1. Ross Eisenbrey, Esq., is vice president of the Economic Policy Institute in Washington DC. Stephen Herzenberg Ph.D., is the Executive Director of the Keystone Research Center in Harrisburg, Pennsylvania.

2. See Ross Eisenbrey and Stephen Herzenberg, *Oklahoma Pension Plans: A House Finally in Order*, November 20, 2013; online at **http://keystoneresearch.org/publications/research/oklahoma-pension-plans-house-finally-order**.

3. "Senate Committee approves future State Employee Retirement Act," *The Norman Transcript*, February 10, 2014, online at **http://www.normantranscript.com/previous/x488686813/Senate-committee-approves-future-State-Employee-Retirement-Act**.

4. Based on the market value of assets, OPERS is 87% funded, primarily because it had high returns in 2012-13 that are not yet fully reflected on the books. See Cavanaugh Macdonald Consulting, LLC, *State of Oklahoma Public Employees Retirement System Actuarial Valuation Report as of July 1, 2013*, p. 1. See also Oklahoma Public Employee Retirement System, *A Call to Serve: Comprehensive Annual Financial Report for the Year Ended June 30, 2013*, online at **http://www.opers.ok.gov/publications**.

5. If contributions to pay off the unfunded liability are imposed only on the current workers left in the closed defined benefit plan, then the benefit cost of these employees for employers (for state agencies in the case of OPERS) spikes as the number of active employees left in the closed plans dwindles. Spreading unfunded liability payments across all workers avoids this spiking problem.

6. For an actuarial study of the impact of closing the Pennsylvania State Employees' Retirement System (SERS) defined benefit plan, see Hay Group, "Actuarial Cost Note Regarding H.B. 1350, P.N.1760," May 2013. For an actuarial study of the impact of closing the Pennsylvania Public School Employees' Retirement System (PSERS) defined benefit plan see "Letter from Dana Spangher, Consulting Actuary, Buck Consultants, to PSERS Executive Director Jeff Clay, Transmitting an Actuarial Note on HB1350 (Printer's No. 1760)," June 11, 2013. For a summary of the two prior studies, see Public Employee Retirement Commission (PERC) (of Pennsylvania), A*dvisory Note for House Bill Number 1350, Printer's Number 1760*. Public Employee Retirement Commission (PERC), A*dvisory*

Note for House Bill Number 1350, Printer's Number 1760. For a summary of all three documents, see Stephen Herzenberg, *A $40 Billion Dollar Oversight,* online at **http://keystoneresearch.org/publications/research/pension-primer-7-40-billion-dollar-oversight**.

7. Beth Almeida and William B. Fornia, *A Better Bang for the Buck*, National Institute on Retirement Security, August 2008, online at **http://www.nirsonline.org/index.php?option=com_content&task=view&id=121&Itemid=48**. William B. Fornia, *Better Bang for NYC's Buck: An Efficiency Comparison of Defined Benefit and Defined Contribution Retirement Savings Plans*, New York City Comptroller's Office, Budget & Policy Bureau, October 2011, Table 6, p. 23. See also Mark Olleman, "Public Plan DB/DC Choices," *PERiSCOPE,* January 2009, Milliman, online at **http://publications.milliman.com/periodicals/peri/pdfs/PERi-01-01-09.pdf**; and Robert Hiltonsmith, *The Retirement Savings Drain: The Hidden and Excessive Costs of 401(k)*, Demos, New York, New York; online at **http://www.demos.org/sites/default/files/publications/TheRetirementSavingsDrain-Final.pdf**.

8. Instead of buying an annuity, holders of individual accounts may prefer to retain a savings account and spend it down during retirement. When they choose this option, however, holders of individual accounts need to save for beyond the median life expectancy or run a 50% chance of running out of funds before they die.

9. Almeida and Fornia, *A Better Bang for the Buck*, August 2008; and Fornia, *Better Bang for NYC's Buck*, October 2011, Table 6, p. 23.

10. Monique Morrissey, *Toward a universal, secure, and adequate retirement system*, October 21, 2009. **http://www.epi.org/publication/toward_a_universal_secure_and_adequate_retirement_system/**

11. Elise Gould and David Cooper, *Financial Security of Elderly Americans at Risk*, Economic Policy institute, Washington D.C., June 6, 2013; online at **http://www.epi.org/files/2013/financial-security-elderly-americans-risk.pdf**.

12. Since 1989, the share of private workers with a defined benefit pension has dropped from 42% to 22%. Prior to 1990, data were maintained only on the share of private, full-time employees in large establishments that had defined-benefit pensions. If trends across all employee groups mirrored the large-establishment decline then the overall share was 57% in 1981.See William J. Wiatrowski, "The last private industry pension plans: a visual essay," *Monthly Labor Review*, December 2012, pp. 3-18; online at **http://www.bls.gov/opub/mlr/2012/12/art1full.pdf**. See especially the first chart on p. 4. See also William J. Wiatrowski, *Changing Landscape of Employment-based Retirement Benefits*, Bureau of Labor Statistics 2011; online at **http://www.bls.gov/opub/mlr/cwc/changing-landscape-of-employment-based-retirement-benefits.pdf**.

13. Nari Rhee, *The Retirement Savings Crisis: Is It Worse Than We Think?* National Institute on Retirement Security, June 2013.

14. See Hay Group, *State of Oklahoma: Total Compensation Market Survey and Analysis Study*, Draft, October 2013 (130-page PPT). If there is a more conventional narrative report that has more detail than the Hay Power Point, we have not had the opportunity to review it. In the absence of more information, questions remain about the methodology used in the Hay Group study. One particular limitation of the methodology is that it appears to depend on confidential Hay Group data and therefore is not transparent or subject to independent review, unlike the method used by Jeffrey Keefe (see the next paragraph in the text).

15. The Hay study analyzed Oklahoma state government pay against two other groups: one was the Hay Group constructed group of private comparison organizations in Oklahoma; the second was state governments in nine other states (six compared on both wages and benefits, two on benefits only, one on salary only). Governor Fallin noted in her address that Oklahoma appears to spend more on benefits than other states. She did not mention that the study showed compensation in Oklahoma state government to be lower than in comparable Oklahoma private sector groups.

16. Kenneth Consulting, "State of Oklahoma Total Remuneration Report for the Compensation Committee," no date (22-page PPT).

17. At the 25th percentile, total compensation is higher for state workers than for comparable private employees, a finding again consistent with other research.

18. Jeffrey Keefe, *Debunking the Myth of the Overcompensated Public Employee: The Evidence*, Economic Policy Institute, September 15, 2010, Table 2, online at **http://www.epi.org/files/page/-/pdf/bp276.pdf**. Keefe has also done a number of state-specific studies, but has not done one for Oklahoma. A state-specific study using Keefe's methodology would likely find that public sector compensation trails private sector (controlling for education, experience, etc.) by more in Oklahoma than nationally. We anticipate this result because other data show that Oklahoma public employees have very lower pay relative to national averages for public employees, whereas overall and private pay levels in Oklahoma are closer to national averages. More specifically, Oklahoma teacher salaries are 80% of the national average while overall wages in Oklahoma (for public and private workers combined) are 88% of the national average (Eisenbrey and Herzenberg, *Oklahoma Pension Plans*, Table 4, p. 16). Bureau of Labor Statistics' data show that the ratio of average public sector wages to private sector wages is 1.04 nationally versus 1.0 in Oklahoma.

19. Keefe, *Debunking the Myth of the Overcompensated Public Employee*, Table 2, p. 6.

20. See March 2013 National Compensation Survey/Employee Benefit Survey, online at **http://www.bls.gov/ncs/ebs/benefits/2013/ownership/govt/table02a.pdf**

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