Iowa Policy Project
A Roadmap for Opportunity

# IPERS works to boost retirees, economy

When state and many local government workers are paid in Iowa, they contribute a share to a retirement system to which taxpayers also contribute. This shared commitment reflects responsible employment practices and a good-faith tool to adequately compensate public workers, who often have skills to find better-paying jobs in the private sector.

For those who seek to reduce public employee compensation, restructuring Iowa's public retirement systems has become a central goal. They are confounded, however, that evidence shows Iowa offers an efficient, predictable way for public employers to spread risk and affordably share costs of funding retirement for a large pool of employees — a structure needing protection.

**Destination:**

**Securing Iowa's public pension systems:**

- **To support retirees after careers of public service**
- **To attract good employees to public service employment**
- **To set an example for better private-sector pensions**

### *The purpose of public pension systems*

Iowa has one large state pension plan covering most state and local government employees and three smaller plans covering police, sheriffs, judges and firefighters. The large Iowa Public Employees' Retirement System (IPERS) plan draws the most attention, particularly from those who would change its "defined benefit" and public management structure — either quickly or a phase-in starting with new employees — to a so-called "defined contribution" arrangement that (1) limits the employer's concern only to its contribution and not whether the resulting benefit adequately meets a retiree's needs, and (2) would put for-profit forces in position to benefit, with new customers for financial planning services. IPERS has weathered stock market downturns and overcome a short period of insufficient contributions. It is meeting its **obligations defined by state law:** to assure secure benefits that promote "economy and efficiency," enable employees "to care for themselves in retirement," and to attract good employees to public service.[1]

### *A funded system*

**C + I = B + E**

While assuring a secure retirement system requires expert financial management, the funding of these plans is explained by a simple formula: **Contributions and Investment Income** ultimately must equal **Benefits and Expenses** of administering the program. When projections of **C+I** into the future equal the projections of **B+E** over the same period, the system is said to be fully funded.

Often, opponents of the current IPERS system will point to the amount of unfunded liability in the system. While a 100 percent funded level is the goal, managers must assure the system can pay benefits, and to invest and seek contribution amounts to make that work over the long term. **IPERS' funded ratio has now risen to 82.4 percent**,[2] up from 81.4 percent the previous year. IPERS notes its investment performance this past year exceeded the expected return by almost a full percentage point, at 7.97 percent.[3]

### *Significant in the economy*

IPERS' 360,000 members (including 120,000 retirees) comprise more than 10 percent of the population of the state of Iowa. Government jobs — state, federal and local — are about 1 in 6 of the nonfarm (or payroll) jobs in the state. Public employees and retirees from public employment have a **significant impact on the economy of Iowa** — not just in the public services they provide to support the economy — but in their own purchases and taxes paid.

Despite some isolated but high-profile pension failures in other states, we have shown[4] the foundations of state pension systems in Iowa, as in most states, remain strong. Defined-benefit plans are designed to achieve the chief purpose of a pension: to assure a secure benefit to a person in retirement. By contrast, defined-contribution plans (e.g., 401ks) and individual retirement accounts place that security at risk.

## DB vs. DC: *Defined Benefit Plans are More Efficient than Defined Contribution Plans in Providing Retirement Benefit*

**Defined benefit (DB)** plans offer a less costly and therefore more efficient way of producing pension income than the alternative **defined contribution (DC)** plans.

***Structural differences —*** A **defined benefit** (DB) pension plan promises a fixed monthly benefit starting at retirement and lasting for the retiree's lifetime. The benefit formula is linked to salary, time of vesting, and years of employment. (A pension is "vested" when a plan member becomes eligible to receive benefits.) Plan formulas differ, but all require the worker to be vested in the plan after a number of years at work, and link the benefit amount to length of employment. For each month of service, the worker accrues this "defined benefit" and the sponsoring employer accrues an equivalent liability. Employer and employee alike make a monthly contribution. **The contribution may change, but the benefit amount is fixed.** If contributions and investment returns on these contributions fall short, the employer makes up much of the difference.

In a **defined contribution** (DC) retirement plan, workers accrue funds in individual accounts administered by the plan sponsor. Employers and employees alike may make monthly contributions to the individual employee's account. **These contributions are fixed, but the amount of benefit is not.** At the time of retirement, the benefits accrued during the working career based on monthly contributions and investment returns will form the total benefit. *Over 30 years, according to a study by the National Institute for Retirement Security and consulting firm Milliman Inc., defined benefit plans delivered an almost 25 percent greater return to participants than defined contribution plans.*

It is easy to see why a defined benefit plan is more efficient in providing a given level of retirement security, which after all is the goal of a pension plan. Suppose the average retiree at age 65 expects to live to age 88. Many will live years longer. Would they be happy with a pension plan sufficient to last only to age 88, with nothing left after that? To be assured of a lifetime pension, through age 95 or older, everyone in a **defined contribution** plan would need to contribute more during their working years to make sure there is enough in each one's account to last that long. **Defined benefit plans**, however, pool contributions and each member need contribute only enough to last to the *average* life expectancy of 88 to assure benefits to the longer lived. **Lifetime pension security can be achieved for all** with substantially less in contributions required.

***Differences in risk —*** The employer bears most risks associated with providing an adequate benefit to the employee in DB plans. There is a temporal risk associated with funds coming up short at the time of retirement. However, through the pooling of risk across thousands of employees, the employer knows that all employees will not retire at the same time. Pooling of funds, and therefore risk, also allows the employer to manage general financial/investment risk associated with changing market conditions. Individuals may outlive their expected pensions but spreading this mortality risk across beneficiaries allows the employer to fund for the average mortality rate. Finally, while employees age, pension plans do not. This long-lived nature of pension plans allows the employer to target high-return investments with fewer risks. The employee can bear risks, however. The employee can bear the risk of inflation deteriorating purchasing power, or from lack of portability of DB funds.

Defined contribution plans, by definition, offer only whatever balance exists, regardless of what the employee might have counted on. The employer has no risk of providing a pre-defined amount of retirement funds. All investment risks are borne by the employee. A market downturn at the time of retirement can severely reduce the employee's nest egg, affecting lifetime income. The employee also takes on the risk of outliving the pension income, or managing a portfolio that he may or may not understand. **By contrast, experts manage Defined Benefit plans.** These experts have the advantage of professional knowledge of financial markets, the pooled resources of many members to spread risk, and the long horizon of an infinitely lived client — a government. This means lower costs to manage and deliver pension benefits.

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[1] Code of Iowa, Chapter 97B.2, Purpose of Chapter.
[2] Iowa Employees' Retirement System, Oct. 24, 2018: "IPERS' FY2018 Funded Ratio Climbs to 82.4 Percent. https://www.ipers.org/node/957
[3] IPERS, August 20, 2018: "IPERS' FY2018 Investment Performance Yields 7.97 Percent." https://www.ipers.org/node/934
[4] Imran Farooqi, Peter Fisher and David Osterberg, Iowa Policy Project, December 2013: "Public Pensions in Perspective." https://tinyurl.com/y9rsnoln