



DB to DC, ASAP!

By Dr. Don Racheter

The Iowa General Assembly (IGA) needs to change the pension system for state employees from the current Defined Benefit (DB) plan to a Defined Contribution (DC) plan as soon as possible (ASAP). Public Interest Institute has written about this problem and its solution numerous times in the past,¹ and has been joined by Iowans for Tax Relief² and the Iowa Chapter of Americans for Prosperity³ in advancing this common-sense plan to protect the taxpayers of Iowa as well as current and future state employees.

For those who are not experts in pensions, DB plans have been the standard in both the public and private sectors in the past. In such a plan, the management and workers negotiate a set amount, generally based on some percentage of the worker's salary (often in his or her last years before retiring), which will continue to be paid to the employee after retirement. Sometimes there is also provision for a cost-of-living adjustment (COLA) to this amount based on the inflation index or other agreed-upon standard.

COLAs have been more utilized in the public sector than the private sector. More generally, pensions and other benefits have been larger in the public sector than the private sector because the politicians who are the bureaucrats' bosses like to put off needed tax increases to pay for such benefits into the future when they will no longer be running for re-election and subject to the voters' wrath for creating a fiscal crisis. However, promising future benefits will generally win them the votes and campaign contributions of the public-sector workers, and especially their unions, while they are running for re-election. What the mainstream media doesn't report, and the average citizen doesn't know, won't hurt them!

As time has passed and the number of employees retiring and drawing pension benefits has grown, most private-sector managers have come to realize that the DB model is no longer sustainable. They have been switching to the DC model, often by maintaining the existing DB plan for current retirees, but shifting all new employees to the DC model as they are hired. In a DC plan, the amount contributed to the worker's retirement account per pay period is fixed (and generally increases with longevity in the job), but the amount the retiree will get back from the account is allowed to fluctuate based on the returns the account earns in the market, similar to a 401 (k) or 403 (b) plan.

Importantly, this DC account belongs to the retired worker and can be passed on to one's heirs, while a DB plan ceases upon death (unless there is a provision for the worker to take a lower pension amount per pay period in return for his or her spouse continuing to receive benefits). Also, since the funds have been passed to the worker's control, the employer cannot lower or eliminate benefits as is possible with a DB plan.

A Publication of: **Public Interest Institute at Iowa Wesleyan University**

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DC plans eliminate what has come to be called the “unfunded-liability problem” for employers in both the public and private sectors. If one has a DB plan, you are contractually obligated to pay out \$X to retirees, even if the corporation, small business, or governmental entity has reduced revenue – or even gone out of business! However, with a DC plan, all the contributions are made while the employer has revenue coming in, and then the employee owns the retirement account and can continue to draw benefits no matter what happens to the business or governmental entity.

The sooner we make this move, the quicker the governmental employees and Iowa taxpayers will be protected from periods of revenue shortfall such as we experienced in 2008-2009. Such a move would be a win-win-win for public employees, Iowa taxpayers, and transparency in pension programs.

Endnotes:

¹Deborah D. Thornton, “IPERS – Is ‘OK’ Good Enough?” INSTITUTE BRIEF (February 2014); Deborah D. Thornton, “Innovative Reforms in Utah – an Example for Iowa” INSTITUTE BRIEF (January 2014); Deborah D. Thornton, “Iowa Legislature and Governor Need to Focus on Pension Reform” POLICY STUDY (October 2013); Deborah D. Thornton, “IPERS Needs More Reform” INSTITUTE BRIEF (February 2012).

²William Petroski, “Iowans for Tax Relief calls Public Employees’ Pensions ‘Huge Liability’ needing Reform in 2014 Session” *Des Moines Register* blog, <http://www.desmoinesregister.com/story/news/politics/2014/01/10/iowans-for-tax-relief-calls-public-employees-pensions-huge-liability-needing-reform-in-2014-session/4410357/> accessed on 15 March 2016.

³“Reform Iowa” <http://reformiowa.com/protect-workers-taxpayers/> accessed on 15 March 2016.

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