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PUBLIC PENSION RESOURCE GUIDE

# Why Do Pensions Matter?

Research has long shown that traditional defined benefit (DB) pension plans make sense for most Americans. This is because traditional pension plans offer middle-class Americans secure and adequate retirement benefits, which help to ensure that they remain in the middle-class into retirement. But DB pension plans are not just good for employees—they also make sense for employers, as well as the broader community.

For employers, DB pension plans are a fiscally responsible and cost-effective way of providing broad-based retirement benefits for workers. Also, especially in the public sector, DB pensions help human resource managers to recruit and retain the highly educated and skilled workforce that they require. Finally, DB pensions have a broad economic footprint, supporting jobs and economic output in local economies throughout the United States, and providing much-needed patient capital to domestic equities markets.

# PENSIONS MATTER TO EMPLOYEES: THEY OFFER THE BEST CHANCE FOR RETIREMENT SECURITY

## DB Pensions Play a Unique Role in Helping Americans Achieve Retirement Readiness

Retirement researchers have long acknowledged the importance of the so-called "three-legged" stool—of Social Security benefits, defined benefit (DB) pension income, and supplemental individual savings—in providing Americans the greatest opportunity to achieve financial security in retirement.[1] Each leg of this stool fills a specific, unique purpose: Social Security is our (near) universal social insurance system that provides a guaranteed, cost-of-living adjusted income for life in retirement; it therefore remains instrumental in keeping older Americans out of poverty[2]—and has done so since at least the 1960s.[3] Yet Social Security was never meant to fully provide for the retirement of middle-class Americans; for the middle class, the second leg of the stool—workplace DB pension plans—are extremely effective means of maintaining an adequate standard of living in retirement.[4] Finally, individual savings accounts—such as workplace defined contribution (DC) plans, individual retirement accounts (IRAs) and all other individual savings—are a helpful way to ensure financial security in the face of additional, possibly unforeseen expenses, such as long-term care costs or guardianship of a loved one.

Research indicates that specific characteristics of traditional DB pension plans make them very effective at supporting retirement security for the middle class. First and foremost, DB pensions provide lifetime income. The default draw-down option for DB plans is a monthly annuity—a series of monthly payments for as long as the retiree lives. The availability of an annuity benefit means that retirees with income from a DB pension have an easier time budgeting for their regular expenses, because the size of their pension check does not fluctuate with interest rates or the stock market.[5]

Secondly, DB pensions are broad-based and secure sources of retirement income. They are broad-based in the sense that, as long as the employee meets the eligibility requirements of the plan, s/he is automatically included in the plan and will earn benefits without having to actively enroll in the program or make investment or other decisions.[6] DB plans are secure in that participants cannot borrow or withdraw money from the plan before retirement.[7]

Additionally, DB pension plans provide special protections for spouses. All DB plans governed by the Employee Retirement Income Security Act (ERISA) must offer a joint and survivor annuity—as the default draw down option—for married participants. State and local DB pensions, although not subject to the same regulations as private plans under ERISA, generally offer these same spousal protections. This means that, should a woman's husband die before her, she will continue to receive a monthly paycheck, even after the death of her husband, for the rest of her life. When one spouse relies on the other spouse's retirement plan to finance his/her own retirement, then, DB pension plans offer specific protections to ensure that the spouse receives a steady, monthly paycheck for the rest of his/her life.[8]

Finally, most DB plans in the public sector offer the added benefit of portability—that is, the ability to move easily from one retirement system to another without a considerable loss in benefits. Public sector DB plans will usually offer either "purchase of service credit," in which a participant may buy service credit for years for which he/she will be ineligible for retirement benefits, or "reciprocity," in which a retirement system has the authority to transfer a plan participant's credit to other systems in the state. Indeed, in 1998 the National Council on Teacher Retirement found that 47 out of 50 public teacher retirement systems offered the purchase of service credit.[9]

Together, these DB pension characteristics are quite effective at helping to ensure a secure retirement income for Americans who have these plans.

## As a Primary Source of Retirement Income, Defined Contribution Plans Are Insufficient

Because the attributes enumerated above are unique to DB pension plans, it may not be surprising that, when DB plans are replaced as the primary source of retirement income with another vehicle, such as a defined contribution (DC) plan, workers do not seem to fare as well in retirement. Indeed, a wide body of research has found that Americans with DB pension income are much more likely to achieve financial security in retirement than those without such pensions.

A 2008 Ernst & Young study found that the trend away from DB pensions and into DC plans in the private sector is having a negative effect on retirement prospects for many newly retired Americans, and that those with guaranteed lifetime income from DB pensions are much better prepared for retirement than those without such income. Among married couples with an income of $75,000 before retirement, for example, those without DB income have a 90% chance of outliving their assets in retirement, as compared to just 31% of those with DB income. The study further finds that new middle-class retirees without DB pension income will have to reduce their standard of living by an average of 32% in order to avoid outliving their assets in retirement.[10]

Among early Baby Boomers (born 1946-1954), Boston College researchers find that 35% are "at risk" of falling more than 10% short of achieving a target replacement rate designed to maintain a pre-retirement standard of living. This number is not only much larger for those with income only from DC plans and for those with no retirement plan, but there is also virtually no difference in the retirement risk of those with DCs and those with no retirement plan—49% versus 50%, respectively. Among households with DB pensions, however, these numbers drop significantly—to 15% for those with just a DB pension, and 12% for those with both DB and DC income. The study finds similar trends among Late Boomers (born 1955-1964) and Gen Xers (born 1965-1972) as well.[11]

Also, the Government Accountability Office recently studied participants in DC-only retirement plans and their account balances, and used this data to project the retirement prospects of these workers. The results showed that a full 37% of workers born in 1990 may enter retirement age with no retirement savings at all, while a full 63% of Americans in the lowest income quartile are projected to have zero retirement savings. Those in the highest income quartile fare best, but are still projected a replacement ratio of just 34% of preretirement income on average from their DC plan.[12]

Finally, the National Institute on Retirement Security recently found that DB pension income plays a substantial role in ensuring that Americans remain self-sufficient in retirement. Specifically, the study found that DB pension receipt was associated with 1.72 million fewer poor households and 2.97 million fewer near-poor households in 2006. Additionally, 560,0000 fewer households experienced a food hardship, 380,000 fewer experienced a shelter hardship, and 320,000 fewer experienced a health care hardship due to their DB pension income.[13]

Each of these studies shows the importance of the three-legged stool in achieving retirement security, as well as the specific importance of DB pension income in maintaining a middle-class standard of living in retirement and avoiding hardships.

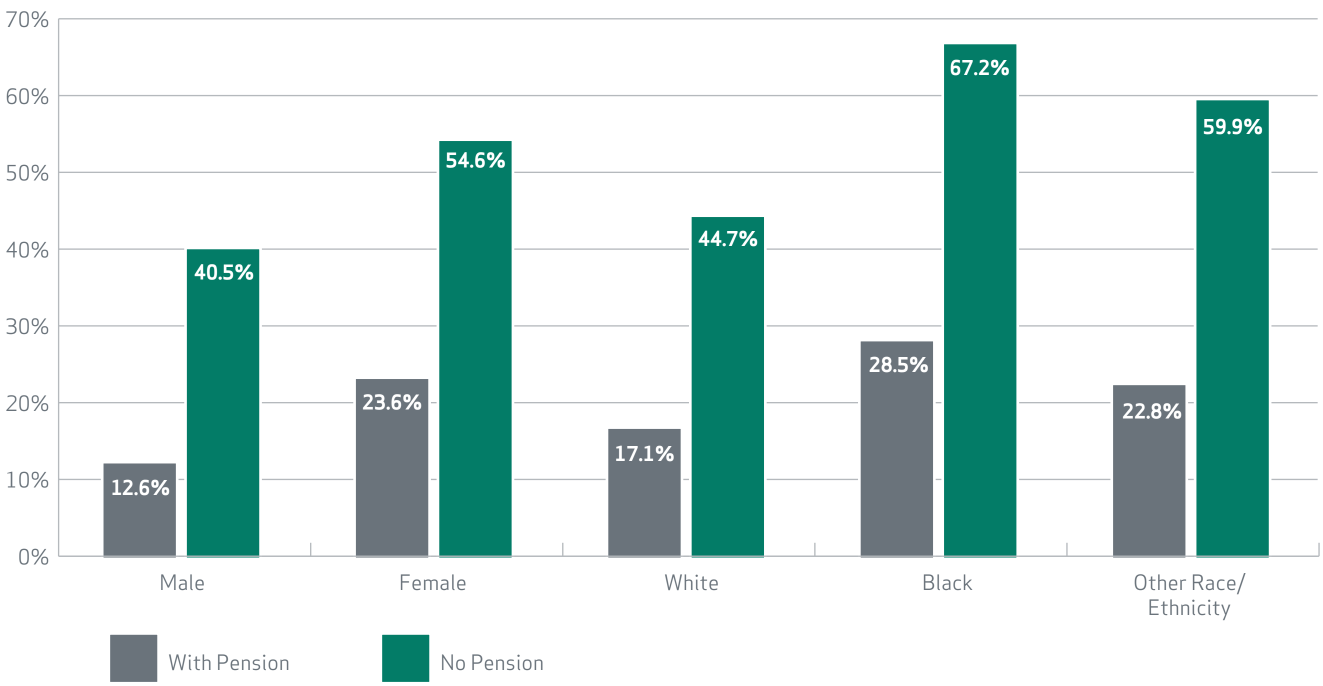
## DB Pensions Reduce Risks of Hardships, Especially for Women and Minorities

The labor economics literature has long shown that women and racial and ethnic minority groups still make less money over their careers than their white male counterparts.[14] Women in particular tend to spend more time out of the workforce, and are more likely to have part-time employment, as compared with men.[15] At the same time, these groups have less access to workplace retirement plans than their white male counterparts.[16] Not surprisingly, these economic disparities during Americans' working lives can spill over into their retirement years, as lower wages throughout a career leads to less ability to save. And with less access to workplace retirement plans, the probability of saving for retirement becomes even lower.[17] For example, Lovell and colleagues found that a full 63% of women feel that they are not saving enough money for retirement, as compared to just 51% of men.[18]

As a result, many studies have found that these groups are more at risk in retirement. A recent Congressional Research Service report found that among Americans aged 65 and older, nearly twice as many women than men were poor,[19] while the Women's Institute for a Secure Retirement finds that more than one-quarter (26.8%) of elder women have incomes below 150% of the poverty line.[20] Among racial and ethnic minority groups, recent research has found that the racial retirement income gap actually increased in the 1980s and 1990s; it is projected that non-white Baby Boomers will have just about half of the total net wealth of their white counterparts in retirement.[21]

Yet DB pension plans seem to play a unique role in shrinking these gender and racial/ethnic gaps in retirement. That is, the percentage of American households classified as poor and near poor drops across gender and race categories when older Americans have pension income. For example, recent research from the National Institute on Retirement Security finds that among elderly households without DB pension income, there is a poverty gender gap of 4.3 percentage points (16.8% of female-headed households are considered poor, versus just 12.5% of male-headed households). Among households with DB pension income, however, this gap is virtually eliminated—just 2.2% of male-headed households and 2.5% of female-headed households with pensions are considered poor. The study finds similar trends for racial and ethnic minority groups; there exists a 17.9 percentage point difference in poverty rates among black and white households without DB pension income, but this gap shrinks to just 3.3% among households with DB pensions.[22] See Figure 1.

Figure 1. **Percentage of Older Households Classified as Poor or "Near Poor"**




Source: Porell, F., and Almeida, B. 2009. *The Pension Factor: Assessing the Role of Defined Benefit Plans in Reducing Elder Hardships*. Washington, DC: National Institute on Retirement Security.

# PENSIONS MATTER TO EMPLOYERS: THEY ARE AN EFFECTIVE RECRUITMENT AND RETENTION TOOL

## Employees, Especially in the Public Sector, Value DB Pension Plans Highly

DB pension plans are not just good for employees—they are also extremely valuable to employers who have specific human resource goals for their workforces. Retirement benefits are a form of deferred compensation; that is, unlike wages and other benefits, retirement benefits are not enjoyed until after the employee has stopped working. Because of their deferred nature, retirement benefits encourage employees to stay with an employer. In a traditional, final pay-based pension plan, workers earn benefits more rapidly the longer they stay on the job; this may lead to higher rates of retention.[23]

Indeed, substantial evidence exists that employees do value DB pension plans highly and are more committed to employers who offer them. A 2008 MetLife survey found that 72% of employees cite retirement benefits as an important factor in their loyalty to their employer.[24] Among employers, a 2004 survey found that 84% of DB plan sponsors believe that their pension plan has some impact on employee retention, with 31% stating that this impact is major. Additionally, of plan sponsors with more than 25,000 employees, a full 58% believe that their DB plan has a major impact on employee retention.[25] A 2005 study by Watson Wyatt found that employees of firms with DB plans place a much greater importance on both attraction and retention than workers at firms with DC plans, and that employees of DB firms have twice the probability of citing the retirement plan as an important factor in choosing their employer as employees of DC firms.[26] Finally, Ippolito finds that workers seem to value pensions so highly that they willingly forego higher wages in order to be ensured guaranteed retirement income.[27]

There is also evidence that public sector employees in particular prefer DB plans to other forms of retirement income, as well as care more about their retirement benefits in general, than private sector workers.[28] Research has shown that certain kinds of employees—such as more experienced workers and union members—seem to value DB pension plans more highly.[29] In general, public sector workers fit this description: Boston College researchers have found that state and local employees are generally more experienced than private sector workers. Also, far more public than private sector workers were unionized in 2005—35% in the public sector versus just 8% in the private sector.[30]

Furthermore, it should be noted that younger public sector workers seem to value their DB plans quite highly as well, even though it is often (incorrectly) assumed that this demographic group prefers DC plans over DB plans. The best evidence of this was a 2008 vote in West Virginia, in which 79 percent of teachers voted to switch from a DC into the DB plan. In that vote, an overwhelming number of younger teachers—over 75 percent of those under the age of 40—decided to make this same switch into the traditional pension.[31]

Perhaps it is thus unsurprising that ample research has shown public employees' enthusiasm for their DB plans. One survey conducted in 2005 found that public employees much preferred traditional DB pensions, and were much less likely than other workers to express a preference for DC plans.[32] Public employees have also been strongly opposed when asked about proposals to switch them out of DB plans and into DC plans.[33] Finally, a 2003 survey found that public employees place a very high value on their pension plans, with nearly two-thirds of employees preferring the DB pension over a DC plan.[34]

## Defined Benefit Pension Plans Can Help Employers Recruit and Retain Skilled Workers

Because DB pension plans are so attractive to employees, employers stand to benefit from the human resource gains that these systems bring to their workforces. Especially among workforces where the human capital investment is high, employers may want to both recruit qualified workers and then do their best to retain them as long as possible once these employees have learned the job well.

The literature shows that DB pensions are an important recruitment and retention tool across industries.[35] As early as 1993, Allen and colleagues found evidence that DB pensions keep workers at jobs longer and offer evidence that workers with pensions are 17% more likely than workers without pensions to stay at their jobs in a single year, all else equal.[36] Even and MacPherson similarly found that firms with pension coverage saw lower turnover rates than non-pension firms, the effect being greater at large firms than at smaller firms. For example, among firms with 25 employees, quit rates were 10% lower among pension firms than non-pension firms; for firms with 5,000 workers these reduced turnover effects were even greater—non-pension firms saw quit rates a full 40% higher than non-pension firms.[37]

Several researchers have attempted to quantify the reduced attrition that pensions bring and have found significant effects. Boston College researchers have found, firstly, that the move from DB plans into DC plans among private sector employers beginning in the 1990s caused employees to begin turning over at higher rates—as opposed to the other way around, as is sometimes supposed. They further find that DB pension coverage increases tenure with an employer by 4 years, as compared to having no retirement system in place, while DB coverage increases tenure with an employer by 1.3 years as compared with DC coverage. Having a DB and DC plan showed the greatest retention effects, as the two plans together increase tenure by a full 3.1 years, as compared with a DC-only plan.[38] In another study, Ippolito finds that DB pension plans reduce turnover by 13 percentage points and quit rates by 20 percentage points, on average.[39]

Furthermore, there is some evidence from the mid-1990s that DB pension plans can actually increase worker productivity, even as they retain employees longer.[40] More recently, in her analysis of productivity changes when a company moves from a DB to a DC retirement plan, Hall finds that those firms that moved from a DB to a DC plan experienced loss of productivity, between 1995 and 2000, especially as compared with those firms who retained their DB plans. She attributes this loss of productivity to the fact that—as noted above—workers turn over more quickly after a switch to a DC plan, and thus were leaving the firm before they had acquired all of the job-specific skills necessary to achieve higher productivity.[41]

Thus, the evidence seems quite clear that employers adopt pension plans in order to attract and retain qualified workers; in turn, workers value their pensions quite highly, and will work for employers with DB pension coverage substantially longer than for both employers with DC plans and those with no retirement plan in place. This increased tenure brings the added value of general productivity increases among such workforces.

## Increased Recruitment and Retention May Be Especially Beneficial to Public Employers

Public sector managers, in particular, may benefit substantially from the human resource gains that DB pensions provide. Unlike private companies that exist to make a profit for shareholders, governments exist to provide essential services—safe streets, clean drinking water, good schools—to citizens and residents. As perpetual entities that do not go bankrupt or out of business, state and local governments are more permanent than private sector firms;[42] this often means that public sector jobs tend to become quite specialized over time. Thus, longer term employment relationships may be mutually beneficial for employers and employees in the public sector.[43]

Notwithstanding the present condition of the labor market, as the Baby Boom generation ages, it may become more difficult for public sector employees to fulfill staffing shortages,[44] especially when competing with private sector jobs, which can offer benefits that public jobs cannot, such as stock options and profit-sharing programs.

Indeed, research has shown that public sector workers have been found to have longer tenures than their private sector counterparts; in 2004, the median tenure of public sector workers was 7.7 years, as compared to just 5.0 years for those in the private sector,[45] for a difference of 35%. To put this number in perspective, a school district with 1,000 teachers, for example, would need to hire an additional 350 new teachers each year if it saw the same level of attrition as the private sector. And, as noted above, there is a good likelihood that the DB pension plan that most public employees receive may be one reason for this increased retention among the public sector workforce.

Thus, DB pensions provide incentives for highly skilled workers—such as researchers, computer programmers, or lawyers—to remain committed to their public sector jobs instead of leaving for higher wages in the private sector.[46]

Also, because many occupations in the public sector have few equivalents in the private sector (for example, public safety and criminal justice), DB pensions provide incentives for employees to make human capital investments in skills which are not easily transferrable.[47] Thus, in fostering deeper attachments between employees and their jobs, DB pension plans are able to help reinforce public sector employers' human resource goals to recruit and retain a qualified, highly skilled and highly specialized workforce necessary to deliver public services.

# PENSIONS MATTER TO TAXPAYERS: THEY ARE AN ECONOMICALLY EFFICIENT AND PRUDENT USE OF FUNDS

## DB Pension Plans Are Economically Efficient

DB pension plans do more than offer retirement security to employees, and a powerful recruitment and retention tool to employers—they are also economically efficient, making them a very good deal for taxpayers. In a recent analysis of the cost to achieve a target retirement benefit under both a DB and DC structure, the National Institute on Retirement Security found that a DB plan costs nearly half as much as the DC plan. That is, the cost to deliver the same retirement income to a group of employees is 46% lower in the DB plan than in the DC plan.[48]

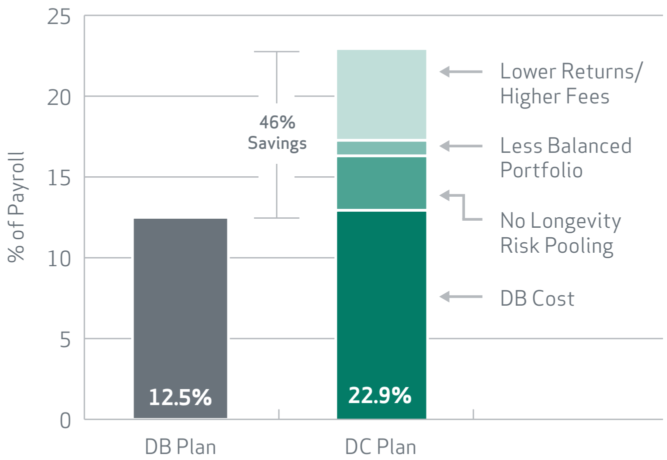
The reason for such cost savings is threefold. Firstly, because DB plans pool the longevity risks of large numbers of individuals, they need only accumulate enough funds to provide benefits for the average life expectancy of the group. In contrast, individuals in DC plans will need to set aside enough funds to last for the "maximum" life expectancy if they want to avoid the risk of running out of money in retirement. Since the maximum life expectancy can be substantially greater than the average life expectancy, a DC plan will have to set aside a lot more money than a DB plan to achieve the same level of monthly retirement income.

Secondly, DB plans are able to take advantage of the enhanced investment returns that come from a balanced portfolio over long periods of time. This is because ongoing DB plans generally include individuals with a range of ages; as older workers retire, younger workers enter the plan. As a result, the average age of the group in a mature DB plan does not change much. This means DB plans can keep a well-balanced portfolio of assets for long periods of time. By contrast, individuals in DC plans must gradually shift to a more conservative asset allocation as they age, in order to protect against financial market shocks later in life.[49] This process can sacrifice investment returns because people may have to sell assets when they are worth too little due to market fluctuations coinciding with retirement timing. Also, they are not able to take advantage of higher expected returns associated with a balanced portfolio.

Thirdly, DB plans achieve greater investment returns than DC plans. These superior returns can be attributed partly to lower fees that stem from economies of scale. For example, asset management fees have been found to average just 25 basis points for public sector DB plans, as compared to 60 to 170 basis points for private sector 401(k) plans.[50] Also, because of professional management of assets, DB plans achieve superior investment performance as compared to the average individual investor. For example, the global benchmarking firm CEM, Inc., recently found that DB plans showed annual returns 180 basis points higher than DC plans between 1998 and 2005;[51] similarly, the consulting firm Watson Wyatt found that DB plans outperformed DC plans by 109 basis points per year, on average, between 1995 and 2006.[52]

According to NIRS calculations, DB plans' longevity risk pooling saves 15%, maintenance of a balanced portfolio diversification saves 5%, and superior investment returns save 26% as compared with a typical DB plan, for a total cost savings of 46%.[53] See Figure 2.

Figure 2. **Cost of DB and DC Plan as a Percent of Payroll**




Source: Almeida, B., and Fornia, W. 2008. *A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans.* Washington, DC: The National Institute on Retirement Security.

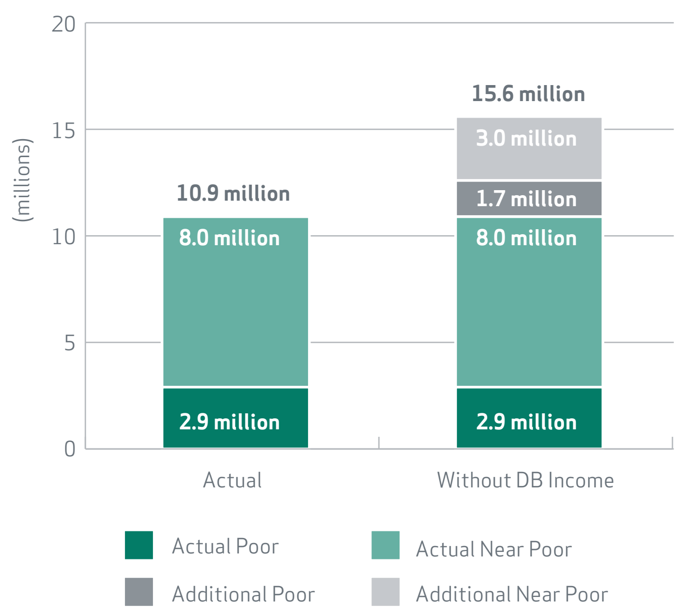
Some observers will argue that it is possible for DC plans to replicate the efficiencies of DBs by designing DCs to incorporate DB-like features, such as automatic enrollment, default investments, and the option to convert balances to an annuity at retirement. While DC plans may certainly improve their performance through efforts like this, an efficiency gap is likely to remain. For example, should an individual under a DC plan wish to receive a guaranteed income in retirement, s/he usually must purchase an individual annuity, because the vast majority of DC plans do not offer an annuity payout option.[54] Because DC plans do not offer the same risk pooling benefits that DB plans impart, however, these individual annuities are much more expensive than automatic annuitization that occurs under a DB plan. This is because any private, individual annuity market presents the problem of adverse selection. In other words, those who expect to live longer will have a greater likelihood of purchasing a life annuity than those who expect to live a shorter amount of time; this increases the cost per participant.[55] DB plans, on the other hand, create a group annuities market—in which all people covered by the DB plan participate, no matter what their life expectancy—which greatly reduces the cost of adverse selection.[56]

On a dollar-for-dollar basis, then, the results are unambiguous: DB plans are inherently more cost-effective than DC plans. That is, should an employer to switch from a DB to a DC plan while retaining the same benefit levels, employees would receive much lower benefits upon retirement simply due to the individualized nature of the DC system and its resulting inefficiencies.

## DB Plans Save Governments Billions in Public Assistance Expenditures

In addition to their economic efficiencies in providing retirement benefits, DB pension plans also save governments money in reducing citizens' need to rely on public assistance. A recent study by the National Institute on Retirement Security finds that DB pensions have been instrumental at keeping elder Americans out of poverty. The study found that 2006 poverty rates among older households lacking pension income were about six times greater than those with such income, and that 4.7 million American households escaped "poor" or "near-poor" classifications due to their DB pension income. (See Figure 3.) Additionally, 560,000 fewer households experienced a food hardship, 380,000 fewer households experienced a shelter hardship, and 320,000 fewer households experienced a health care hardship because they had income from a pension.[57]

Figure 3. **Number of Poor/Near Poor Older Americans, Actual and Projected (Without DB Income)**




Source: Porell, F., and Almeida, B. 2009. *The Pension Factor: Assessing the Role of Defined Benefit Plans in Reducing Elder Hardships.* Washington, DC: National Institute on Retirement Security.

When fewer households experience poverty and financial hardship, federal, state, and local governments see a cost savings in terms of public assistance expenditures avoided. The report calculates a savings of some $7.3 billion in public assistance expenditures in 2006 attributable to receipt of pension income.[58] In the absence of DB pensions, spending on public assistance for the elderly would be about 40% higher than we actually observe.[59] This savings is significant, particularly given the pressures on safety net programs during the current fiscal crises experienced at all levels of government throughout the country.

These findings underscore the vital role that DB pensions play, not only providing an economically efficient road to retirement, but also in saving money on costly public assistance programs provided by federal, state, and local governments around the country.

# BEYOND RETIREMENT: WHY PENSIONS MATTER TO LOCAL ECONOMIES AND CAPITAL MARKETS

DB pension plans have positive impacts for employees, employers, and taxpayers. But their economic impact also reaches well beyond the retirees who receive pension checks. DB pensions play a vital role in the national economy as well as in local economies across the country, largely due to two different types of economic channels: the benefit channel, in which retirees' expenditures create incomes for others in the economy, and the investment channel, in which the investment of pension assets provides capital to businesses. Each of these impacts is substantial.

## Expenditures from DB Pensions Have a Broad and Deep Economic Impact

Expenditures made out of DB pension plans have a broad economic impact, both nationally and on the local level. This is due to the fact that when a retiree receives a benefit payment from her pension fund, s/he does not stuff that money under a mattress—s/he spends the money on goods and services in her community, thus supporting the local economy and industries where s/he resides. Local economies, then, benefit from the regular expenditures these retirees make on purchases such as food, medical services, and transportation.[60] These expenditures have a ripple effect, due to what economists call the multiplier effect, as shown in Figure 4.[61]

The National Institute on Retirement Security recently measured the overall economic "footprint" of benefits paid by state and local government pension plans to retirees.[62] NIRS finds that in 2006, over $151.7 billion in pension benefits were paid to 7.3 million retired employees of state and local government and their beneficiaries (typically surviving spouses). Expenditures made out of those payments collectively supported more than 2.5 million American jobs that paid more than $92 billion in total compensation. Pension expenditures also supported over $358 billion in total economic output nationwide and over $57 billion in federal, state, and local tax revenue.[63]

Furthermore, NIRS found that state and local pension expenditures have large multiplier effects. The study calculates a pension expenditure multiplier, which describes the impact on total output for each dollar paid out in pension benefits, and finds that for each dollar paid out in pension benefits, $2.36 in total economic output was supported. (See Figure 5.)

Figure 4. **The Multiplier Effect**

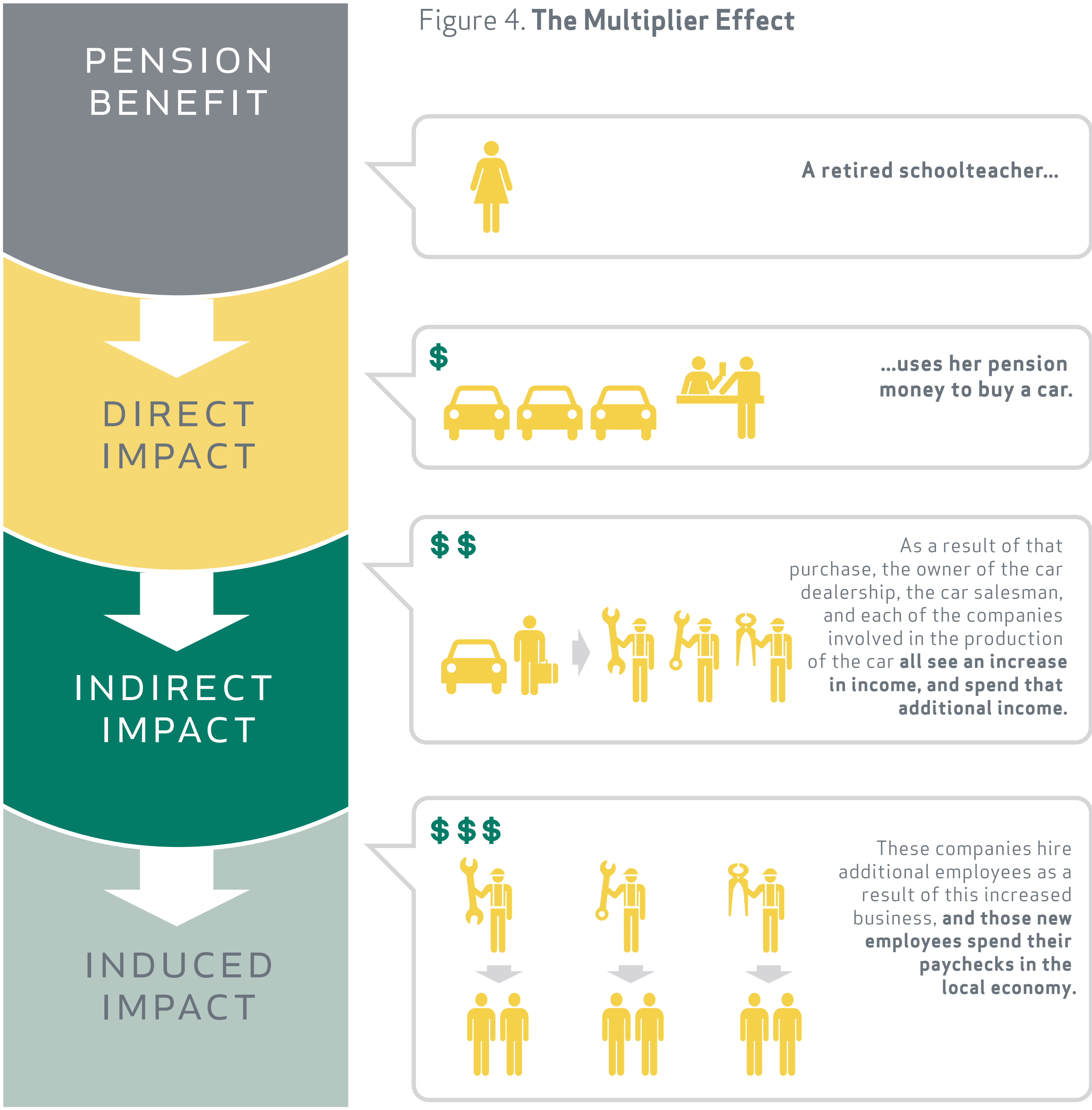
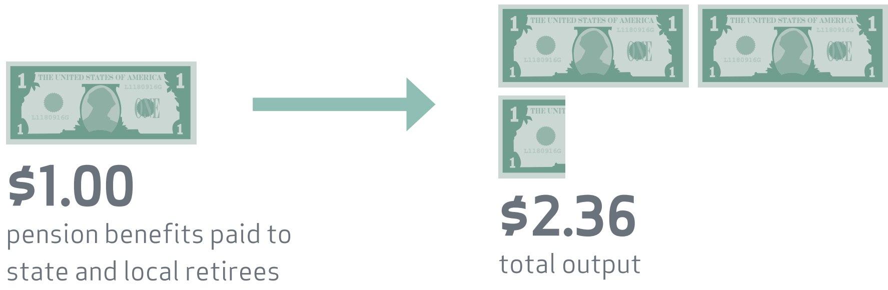
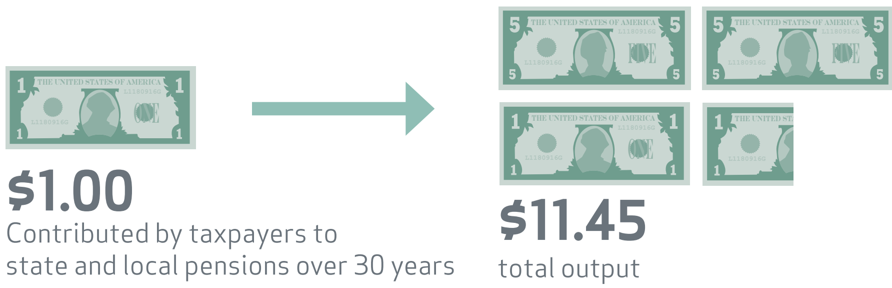


Figure 5. **The Pension Expenditure Multiplier**




Source: Boivie, I., and Almeida, B. 2009. *Pensionomics: Measuring the Economic Impact of State and Local Pension Plans*. Washington, DC: National Institute on Retirement Security.

Figure 6. **Taxpayer Investment Factor**




Source: Boivie, I., and Almeida, B. 2009. *Pensionomics: Measuring the Economic Impact of State and Local Pension Plans*. Washington, DC: National Institute on Retirement Security.

And for every dollar contributed by taxpayers to state and local pension funds, $11.45 in total output is supported in the national economy, as shown in Figure 6. This so-called "taxpayer investment factor" is quite large because, as mentioned previously, employee contributions and investment earnings finance most of the benefits, not taxpayer dollars.

Nationally, the largest economic impacts were seen in the manufacturing, health care and social assistance, finance and insurance, retail trade, and accommodation and food services sectors.

It is also important to note that traditional DB pensions act as "automatic stabilizers" for the economy. DB pension payments to individual retirees do not fluctuate with the stock market or other macroeconomic indicators. Because retirees receive a regular monthly benefit, they can continue to spend on basic needs, providing important stimulus to local economies even during tough economic times, making DB pension income that much more important to local economies throughout the country.[64]

## DB Pension Investments Are Crucial to Domestic Capital Markets

DB pensions are pre-funded, which means that investment earnings make up a large portion of the system's funding over time. But DB pension investments create other economic gains as well. Investment of pension assets provides capital to businesses to develop products, invest in new technologies, and even create jobs.

As mentioned earlier, DB pensions have longer time horizons than savers in DC plans, and because of this they can achieve greater stability in asset allocations. This "patient capital" offers benefits for financial markets as a whole, since professional investors who follow a long-term strategy are less likely to cause market disruptions by chasing short-term returns.[65] It also means that DB pensions invest in stocks and equities for the long term, but also that they can allocate a portion of funds to alternative investments—such as hedge funds, venture capital, and private equity—that DC investors cannot because of their shorter term time horizon. Such asset classes are often incorporated into a portfolio not because of higher expected rates of return, but because they can offer uncorrelated returns that are somewhat insulated from stock market shocks.[66] That is, should the stock market as a whole see a substantial downturn, alternative assets can be somewhat more shielded from losses.[67]

In 2007, for example, a survey conducted of the 52 largest public pension funds reported that the average allocation to private equity was 5.7% of assets, and the average allocation to hedge funds was 1.1% of assets.[68]

Table 1. **Assets Held in Public and Private Sector Pension Plans, 2007 (in billions of dollars)**

| | Cash and Liquid ssets | Treasury & Agency Debt | Corporate & Foreign Bonds | Stocks | Mutual funds | Other Investments | Total |
|---|---|---|---|---|---|---|---|
| Public Plans | $64 | $534 | $249 | $1,981 | $296 | $16 | $3,139 |
| Private DB Plans | $55 | $254 | $212 | $1,471 | $226 | $116 | $2,334 |
| (as a percent of total) | | | | | | | |
| Public Plans | 2% | 17% | 8% | 63% | 9% | 1% | 100% |
| Private DB Plans | 2% | 11% | 9% | 63% | 10% | 5% | 100% |

Source: Board of Governors, Federal Reserve System. 2007. *Flow of Funds Accounts of the United States*. Washington, DC: Board of Governors. Stocks include both foreign and domestic equities.

Yet even such a relatively small proportion of total assets can go a long way in promoting new business ventures. DB pensions' influence on the venture capital industry, for example, has been substantial. Since the 1980s, private independent venture capital funds have steadily increased the amount of capital under management—from just over $4 billion in 1980, to $28 billion in 1990, and $257 billion in 2007. Many attribute this investment growth to the gradual lifting of restrictions on public pension plan investment opportunities, which allowed pensions to invest in venture capital.[69] Venture capital has subsequently helped to launch companies such as Federal Express, Staples, and Starbucks.[70]

Today, nearly 90% of all venture capital investments come from institutional investors such as DB pension plans and endowment funds. As a venture capitalist recently testified before Congress, DB plans provide "a critical source of capital formation for both our industry and the start-up companies in which we invest." He further testified, "The U.S. venture capital industry would not be the economic engine it is today without the strong investment participation from defined benefit plans."[71]

## CONCLUSION: PENSIONS MATTER

As outlined above, DB pension plans are enormously important to employees, employers, taxpayers, and the broader U.S. economy. The steady, reliable income that retired Americans receive from traditional pension plans is invaluable to retirees, as it still offers the greatest chance for middle-class American workers to maintain a middle-class standard of living in retirement.

Because Americans are aware of the uniquely valuable benefits that DB pension plans provide, most workers value traditional pensions quite highly. This means that, for employers, DB pensions are a highly effective recruitment and retention tool, as pensions help to increase the tenure of workers who have access to them. DB pensions have even been found to increase productivity among workforces.

Furthermore, taxpayers benefit when state and local governments offer their workers DB pensions. DB pensions offer significant economic efficiencies—to the tune of a cost savings of 46%, as compared to DC plans. Also, taxpayers see additional economic benefits in the fact that pensions keep retirees out of poverty, and therefore off of public assistance programs; in 2006, public assistance spending was 40% lower than it would have been, had retirees with DB pensions not had such benefits.

Finally, DB pensions support local economies around the country with the stimulus of steady income streams to the local businesses where retirees spend their pension checks. In 2006, state and local pension expenditures supported 2.5 million American jobs and $358 billion in economic output nationwide. Furthermore, DB pension funds offer a reliable source of patient capital to entrepreneurs and investors nationwide, with nearly 90% of all venture capital investments coming from institutional investors such as DB pension plans and endowment funds.

Thus, although DB pension plans do an excellent job at providing retirement benefits for many Americans, they also do much more than simply that. Pensions also bring considerable benefits to employers who offer them, taxpayers who assist in funding them, and the broader economy.

## ENDNOTES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61 When money is spent at a local business, that business sees an increase in revenue, thus boosting the economy initially. But that initial purchase generates even more local income, as shop owners will spend more money at other local businesses, purchasing more input goods to make additional products. Then, those input business owners will also spend more money in the local economy to increase their production, and so on. Additionally, with the increase in revenue, local merchants may hire extra workers, further fueling the local economy. Thus, with each new round of spending, additional revenue is generated, expanding job creation, incomes, total output, and tax revenue to the local community.

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