Reason Foundation Working Paper 09-27-2024

Best Practices in Optional Defined Contribution Plans

reason FOUNDATION

Zachary Christensen

Reason Foundation

zachary.christensen@reason.org

September 27, 2024

Executive Summary

Retirement plans serve a vital purpose for government employers. Public workers depend on these plans to build retirement security so they are prepared for their time after their working life. State and local governments use these plans to partner with employees in pursuing their individual retirement security goals. The most common retirement offering for public workers comes in the form of a defined benefit (DB) pension, but shifts in employee behavior suggest a need to modernize this approach for new hires. With changes in workforce mobility, government employers must expand their offerings beyond the traditional pension plan to appeal to a broader range of career paths. An increasingly popular and effective way to do this is by adding an optional defined contribution, or DC choice, plan that new workers can select at the beginning of their employment.

As public workers come to expect a shorter tenure, or simply want more control over their retirement contributions, DC choice plans can be optimal over the commonly offered pension plan. An examination of how benefits accrue differently between these two options shows that one type of plan can work better than the other, depending on various factors like age of hire and years of service. The best way to accommodate all workforce situations is to allow each new worker to select the option that they believe best works for them. In the case of the New Mexico teacher plan, an educator hired at 25 is only better off after full retirement when compared to a DC plan. Before full retirement, that teacher will likely only get about 70% of the benefit they would have gotten in the DC plan.

Choice plans—plans that give the option to choose between a DB or a DC plan at the time of hiring—are beneficial not just for the employee but can also benefit the employer. With the proliferation of unfunded pension liabilities among U.S. governments, optional DC plans can serve as valuable risk mitigation solutions. For example, Utah saw significant improvements to its funded status after the implemented a DC choice system in 2012.

For those looking to implement or improve an optional DC plan to go alongside an existing pension, several key policy decisions are important to understand:

- Contribution rates must be adequate to achieve the committed retirement goals.
- There must be options for guaranteed retirement income.
- Proper benefit education must be provided to new members making the choice.
- The benefit selection period must be ample.
- The default option set must work for the particular workforce.

Each one of these policies can have an enormous ripple effect. For example, in Florida in 2018, the implementation of a DC default—steering new hires who did not indicate a preference between the two available options to the DC plan—had a notable impact on the enrollment rates between the system's two options. When designing choice plans, policymakers must understand the crucial role that contributions play and how this role differs between DB and DC

options. While both options aim to provide retirement security, pensions and DC plans diverge in how they approach contributions. DC plans work to save enough money in individual accounts, while pensions pool this money and make regular adjustments to contributions to address emerging funding shortfalls. With these core differences in mind, setting DC contribution rates to match the pension plan can lead to contributions misaligned with the DC's primary objective and is not a wise idea. In the past, this approach created challenges for Florida's public employee retirement plan, which was eventually addressed with a realignment of DC contribution rates. The Michigan State Employee Retirement System (MSERS) set the rate for its optional DC plan around best practices for retirement security, which, in this case, provided employees with an incentive to choose the DC option.

With thoughtful implementation of these policies, policymakers can expand on the options available to government workers, establishing a more robust retirement system that better achieves the goals of a public employer and better suits the individual public employee.

Table of Contents

Part 1: Introduction

Part 2: Advantages of Using Choice Plans

2.1 Benefit Advantages of a DC Option for New Hires

2.2 Increased Portability and Flexibility in DC Plans

2.3 Slowing the Growth of Unfunded Pension Liabilities

Part 3: Components of a Successful DC Choice Plan

3.1 Establishing Specific Objectives for a DC-Choice Plan

3.2 DC-Choice Plan Structure

3.2.1 Adequate Contributions

3.2.2 Potential Problems in Equal Rates Between DC and DB Plans—Florida Retirement System (FRS)

3.2.3 Uneven Rates Between DC and DB Plans—Michigan State Employee Retirement System (MSERS)

3.2.4 Guaranteed Lifetime Income Options

3.3 DC-Choice Execution

3.3.1 Educational Programs and Materials

3.3.2 Selection Period

3.3.3 Setting Default Options

3.3.4 Impact of Defaults on Membership—Florida Retirement System (FRS)

Part 4: Conclusion

PART 1 Introduction

Through taking an active role in promoting the retirement security of their employees, state and local governments strive to offer attractive and cost-effective post-employment benefits. Traditionally, public employers in the U.S. have offered pensions as the primary strategy for employees, but behaviors in career mobility and longevity have changed quite a bit over the last generation of workers.

In the past, workers tended to remain with a company or government employer for the entirety of their careers. This is no longer the norm.[1] As technology facilitated the search for employers and employees, the modern workforce has become more transient, moving more readily between employers and careers, upskilling independently, and often moving from one place to another geographically. This shift has necessitated a more flexible network of retirement options that allow each individual to select the retirement strategy that best fits their particular needs.

A common way to expand on the usual retirement options for public workers is through individual accounts. There are many different types of individual accounts. Still, the defining characteristic is that retirement contributions remain with and follow the individual, meaning that when they move from one job to another, they are able to take their retirement savings with them. As this offers a higher level of portability and flexibility, this type of retirement plan is becoming increasingly enticing to workers, including those employed by government entities.

Over the past few decades, many state and local employers have begun offering a choice to new workers: the traditional pension or a more portable individual account option. This brief examines the best practices in offering an optional defined contribution plan. This type of option-based offering can greatly expand a government's ability to serve the retirement needs of a wider variety of workers, which—with proper execution—can optimize a retirement system for both government employees and employers.

Public retirement systems that incorporate an optional DC plan—referred to in this paper as a DC choice plan—provide a choice between one type of retirement plan or an alternative defined contribution (DC) plan at the time of hire. The new hire typically has a window between six months to a year to make their decision, after which they are locked into their selected plan for the rest of their employment.

Most governments that adopt this approach offer a DC choice plan as an alternative to the traditional and most common defined benefit (DB) pension plan. Optional DC plans can also

---

[1] Amy Adkins, "Millennials: The Job-Hopping Generation," Gallup, 2023. www.gallup.com/workplace/231587/millennials-job-hopping-generation.aspx (30 Aug 2024).

operate alongside any other type of retirement plan to increase risk sharing.[2] As the name suggests, the key element of this type of plan is the ability for new employees to choose between this and other plan options, depending on what they decide is the best option for them.

This brief examines the advantages of an option DC plan, both to public workers and to the governments that sponsor public retirement plans. It also explains the key components of a successful DC choice plan structure, so policymakers can evaluate their current retirement system and deploy an optional DC plan that meets the needs and objectives of public employees and government employers.

PART 2 The Value of Choice in Retirement Plans

The flexibility to choose between multiple available retirement plan options is important because a traditional one-size-fits-all approach often optimizes how benefits accrue for the very limited group of employees who stay their entire career, leaving many employees behind and without adequate or optimized savings from their tenure. If an employee plans on working in their position until the end of their career, they will often find more value in a traditional pension plan. If a public employee anticipates that they will not stay in their job long enough to take advantage of a traditional pension benefit, then a DC plan may better achieve their retirement goals. Offering a choice between both covers both of these situations and, therefore, optimizes a retirement plan for a much wider range of valued workers.

2.1 Benefit Advantages of a DC Option for New Hires

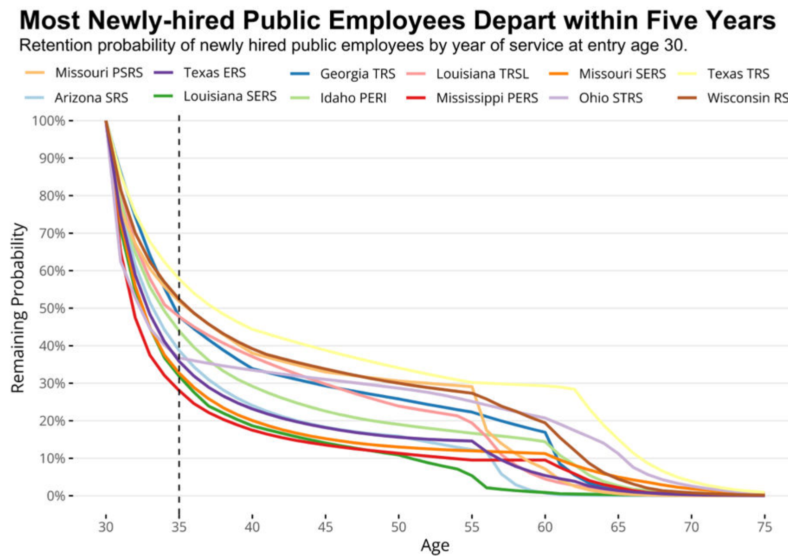
Figure 1 displays the retention expectations for each year of service for a new hire starting at age 30 for several major state-run teacher and general public employee pension plans in Missouri, Texas, Georgia, Louisiana, Arizona, Idaho, Mississippi, Ohio, and Wisconsin. As the analysis illustrates, the probability of an employee remaining drops dramatically over time, with the steepest decline occurring in the first few years. All of the plans featured in the figure require at least five years of service before they gain access to any type of pension benefit. On average, the minimum vesting period for state-defined benefit pension plans is 6.9 years.[3]

---

[2] Ryan Frost, “Defined Benefit Plans: Best Practices in Incorporating Risk Sharing.” Reason Foundation, 2022. www.reason.org/policy-brief/best-practices-in-incorporating-risk-sharing-into-defined-benefit-pension-plans/ (16 Aug 2024).

[3] “Pension Vesting Periods by State,” Equable, 2022. www.equable.org/pension-vesting-periods-by-state/ (23 August 2024).

Figure 1. Retention Rates to Years of Service for Various Public Pensions



Source: Reason Foundation. Modeled from official withdrawal and retirement rates from each plan's valuation report. Analysis forecasts retention probability for someone hired at age 30.

This analysis shows that, among this selection of public pension plans, only 57.8% of new hires are expected to stay long enough to vest their defined benefits and qualify for a pension benefit.[4] These retention rates are common for public employers, with most public pensions using the same or similar new hire retention actuarial assumptions.

This means that many new hires going into a pension plan will end up leaving with nothing more than their own contributions and will not be able to take advantage of the contributions made on their behalf by their employer. In many cases, this results in them missing out on significant retirement savings early in their careers, a crucial time to begin establishing retirement security.

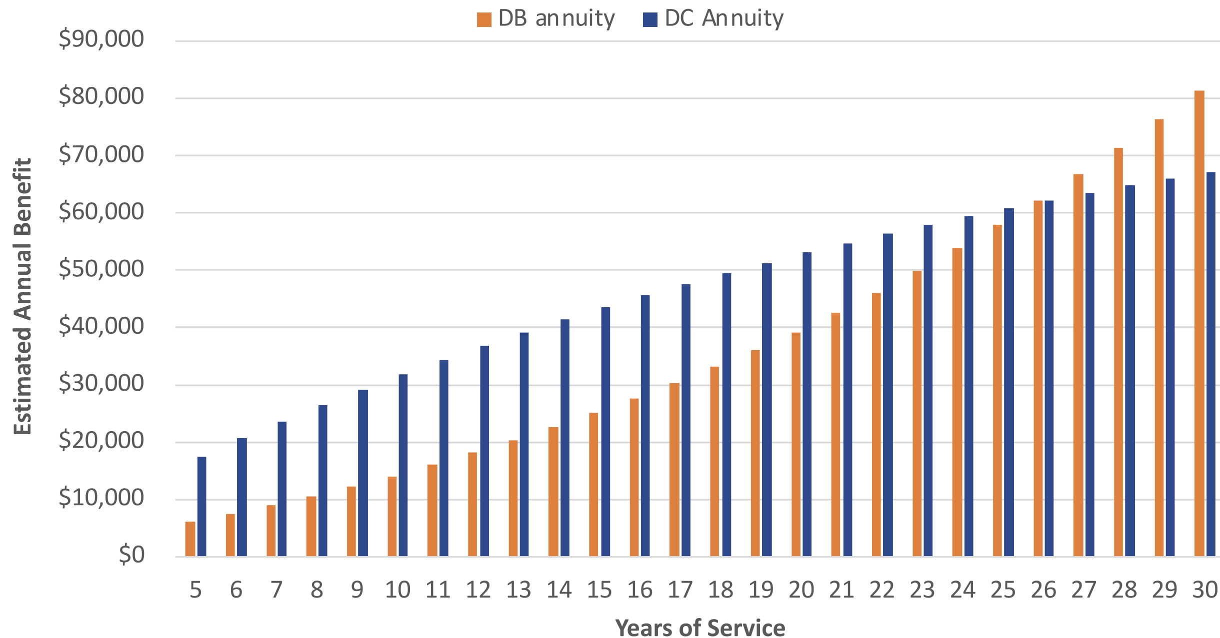
Even among those who stay long enough to vest in pension benefits, a DC plan can still be more advantageous in many situations. DB and DC plans accrue benefits very differently, meaning one type of plan may outweigh the other depending on how many years of service a worker dedicates to the job. Pensions are generally structured to be advantageous to employees who stay through a decades-long career. Pension plans concentrate the bulk of an employee's benefits at the end of their career rather than spread out evenly throughout.

---

[4] Mariana Trujillo, Steve Vu, and Truong Bui, "Most Public Employees Leave Jobs Before They Vest in Pension Systems," Reason Foundation, 2024. www.reason.org/commentary/most-public-employees-leave-jobs-before-they-vest-in-pension-systems/ (30 August 2024).

As an example, Figure 2 compares the retirement benefits that accrue for the current DC plan offered to non-teacher public employees in Alaska to a DB pension benefit proposed in the 2024 legislative session.

Figure 2: Annuity Earned at Tenures of Service for Alaska's PERS DC and DB Plans



Source: Pension Integrity Project 30-year benefit forecast of Alaska PERS (non-public safety) DC & DB plan. Analysis uses entry age 30, assumed 7% return, 5.89% annuity payout rate, and 2.75% wage increase rate.

For public employees in Alaska who leave within one or two decades of service—a scenario that reflects the career trajectory of most of the workforce—the DC plan proves to be significantly more advantageous. For instance, a public employee who starts at age 30 and exits after 10 years of service in Alaska's public employee system to start a family, pursue further education, or transition to the private sector (assuming a 7% annual investment return on savings) would secure a retirement benefit of $30,000 per year under a defined contribution plan, compared to just $10,000 under a defined benefit plan. This disparity arises because contributions to DC plans continue to compound until retirement, while DB benefits, as their name implies, are fixed at the time of departure. DB benefits are calculated by a set formula and do not benefit from compounding once the employee leaves, often resulting in more certain but significantly lower retirement savings.[5]

Moreover, even for those who serve extended tenures (25+ years) under a DC plan, the difference in forgone benefits compared to a DB plan is relatively modest. If an employee

---

[5] Mariana Trujillo, "Why Defined Benefit Plans Fail the Majority of Public Workers," Reason Foundation, 2024. www.reason.org/commentary/why-defined-benefit-plans-fail-the-majority-of-public-workers/ (30 August 2024).

initially chooses a DC plan but ends up staying in the system longer than expected—where a DB plan might have offered slightly higher benefits—the DC plan remains a competitive option. Selecting a DC plan would not be a gamble; rather, the defined benefit would be.

This analysis illustrates how DC plans often generate higher retirement benefits for most public workers. While this is a specific analysis based on the benefits and assumptions of a single plan in Alaska, these annuity patterns repeat themselves all over the country. It is clear that a large cohort of public employees could benefit from having the option to choose between a DC benefit and a DB pension.

2.2 Increased Portability and Flexibility in DC Plans

Portability in the context of pension plans refers to the ability of a person to carry over their benefits from one plan to another if they change their job. Because traditional public pension plans are tied to an employer, workers cannot transfer their existing plan to a new job, as they could with DC benefits. If they change jobs, they have to restart the process of accumulating retirement savings with potentially high penalties for withdrawing benefits.

In a choice-based public retirement system, new workers have the option to select the retirement plan that best fits their long-term career path. If they don't anticipate staying in that position for an entire career, or if they would prefer a more portable option that they can take with them, a DC plan could be a better choice.

New members of government retirement plans will find themselves in a variety of situations, whether planning to stay in a job for a lifetime or planning to leave after a couple of years. There are also countless other considerations—existing wealth, health expectations, family arrangements, flexibility during unexpected emergencies, and others—that should play a part in an individual's retirement planning. This variety of situations demonstrates the value of having more flexibility in planning one's retirement and some of the shortfalls of a one-size-fits-all approach. With more options available to new workers, a retirement system has the ability and flexibility to serve a wider range of situations, which is typically in line with its core purpose of providing adequate and cost-effective retirement security to *all* members.

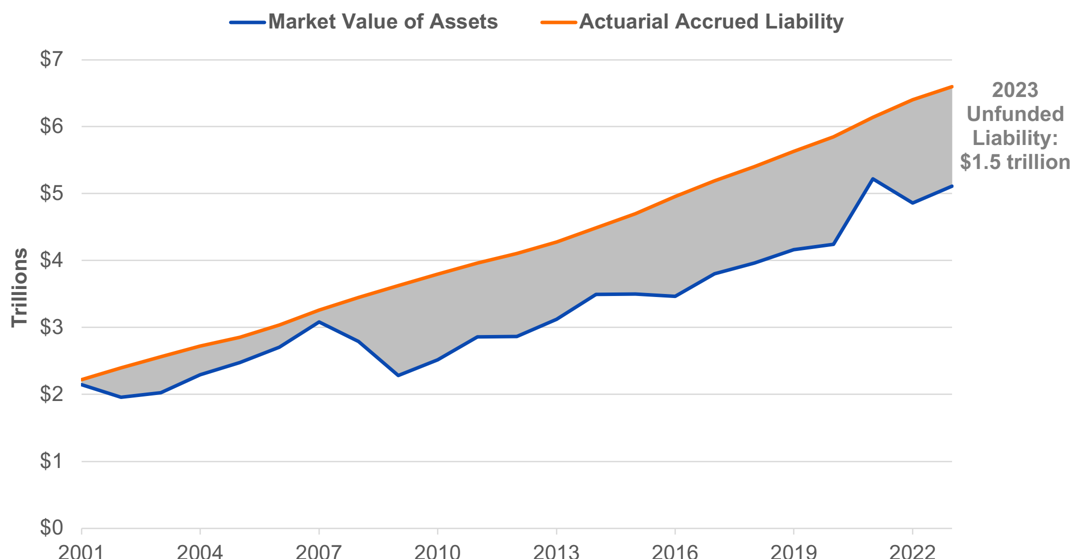
2.3 Slowing the Growth of Unfunded Pension Liabilities

The flexibility of a choice-based retirement plan is beneficial not only for employees but also for government employers and, consequently, taxpayers.

For most DB plans, the investment risk from market volatility is entirely on the employer. There is no market risk borne on the employee side. Because of this feature inherent in pensions, underperforming investment returns and insufficient contributions over several years have

generated massive unfunded liabilities for state governments, totaling over $1 trillion in 2023.[6] These funding shortfalls have required massive additional payments from public employers, which has crowded out budgets and hindered governments' abilities to address other priorities or provide other crucial services.[7]

Figure 3: Liabilities Outpacing Assets for State Pensions Nationwide



Source: Pension Integrity Project analysis of U.S. state-run public pension systems actuarial data. Assets are reported on a market value. The shaded area indicates unfunded liabilities.

DC plans avoid the challenge of unfunded liabilities altogether since what is owed is a simple reflection of what has been contributed. There are no unexpected government costs associated with employees enrolled in a DC plan, which means the employer simply structures an adequate level of contribution (usually shared between the employee and the employer).

While a DC plan comes with a higher degree of both flexibility and market risk for employees, it is still possible for retired teachers and public workers to secure guaranteed lifetime income with a DC plan. Retirees can purchase annuities that give a guaranteed income for the rest of

---

[6] Pension Integrity Project, "Forecast: State Pension Debt Totals $1.3 Trillion at the End of 2023," Reason Foundation, 2023, www.reason.org/data-visualization/forecast-state-pension-debt-totals-1-3-trillion-at-the-end-of-2023/?gad_source=1&gclid=Cj0KCQjw28W2BhC7ARIsAPerrcKVsiRtB2f6Gnsf8_rQMuWV3Rk-xCK-LbA7LX_r9wz_J6kZLsMH_SUaAmKxEALw_wcB (9 August 2024).

[7] "The Big Squeeze: How Unfunded Pension Costs Threaten Educational Equity," Pivot Learning, 2019. https://equable.org/wp-content/uploads/2019/08/The-Big-Squeeze-How-Unfunded-Pension-Costs-Threaten-Educational-Equity.pdf (9 August 2024).

their life.[8] Note that the analysis displayed in Figure 2 applies this logic by calculating the guaranteed lifetime annuity a retiree could secure with their DC benefits.

The advantage of offering an optional DC plan for public workers is that a government employer can give each new hire the ability to select what is best for them, while simultaneously slowing the growth of runaway costs associated with pension benefits. Providing this option with comprehensive reforms to manage the risk of a pension plan has proven to be particularly effective in improving the long-term security of retirement systems.

Several states have implemented DC choice plans over the years. One of the most notable examples of success with this approach, Utah Retirement Systems (URS), established a DC choice plan as a part of sweeping reform and has seen considerable results in pension solvency since then. Utah passed pension reform in 2010 and implemented major risk-balancing changes to the pension for new hires and a choice plan (an optional DC plan) in 2011.

The risk balanced pension gave new hires the option to have a guaranteed lifetime benefit but transferred some of the risk of unexpected costs to the employee. Under the reformed URS pension, state employers pay an amount equal to 10% of a members pay toward the pension fund, with employees contributing nothing. If actuarial requirements were to exceed that 10%, the employee would be responsible for any excess and would see that amount come out of their paycheck.

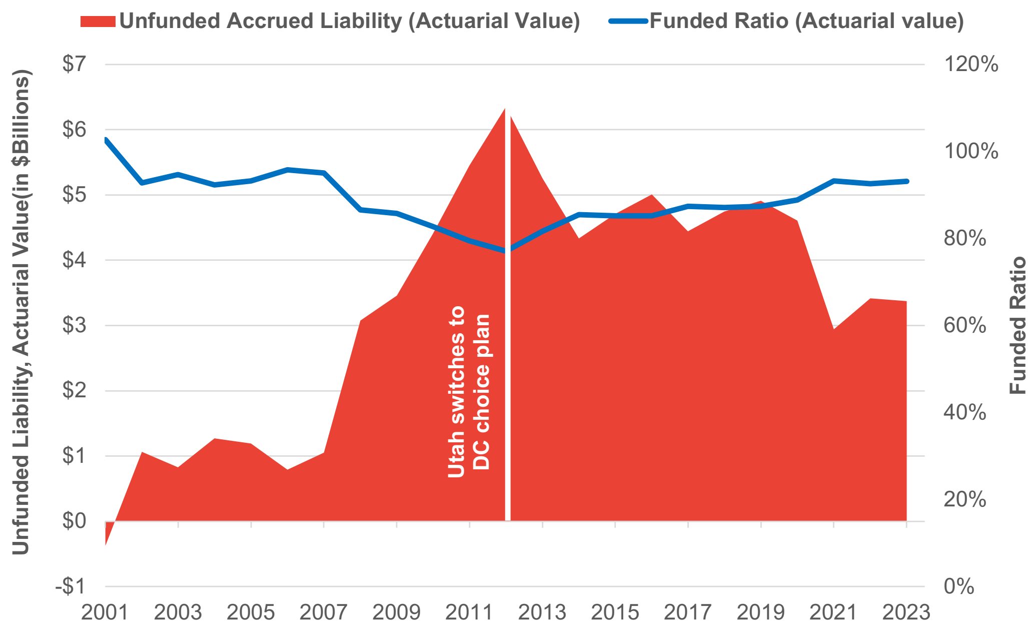
Lawmakers also established an optional DC plan, which new hires could choose within their first year. This option had employers contributing an amount equal to 10% of an employee's pay to their own 401(k) account. The 2011 reform made the pension option the default, meaning anyone who did not make an active selection would be automatically enrolled in the DB.

At the time of the legislation, its funding ratio was around 80%, and its unfunded liabilities were around $4.1B (Figure 4). Before the system could feel the effects of the reform and while it was still reeling from major losses in 2008, URS funding dipped to 77% in 2013. The plan's funding after over a decade of implementing the choice-based program along with other risk and cost-reducing reforms on the pension benefit promised to new hires, has improved its funded ratio to 92.6%. Its unfunded liabilities stabilized (ceased growing) and are reported to have decreased by almost half, to $3.4B by 2023.

---

[8] Richard Hiller, "Defined Contribution Retirement Plans Can Offer a Variety of Options for Secure Retirement Income," Reason Foundation, 2020. www.reason.org/commentary/defined-contribution-retirement-plans-can-offer-a-variety-of-options-for-secure-retirement-income/ (9 August 2024).

Figure 4: Unfunded Liabilities and Funded Status of Utah Retirement Systems (URS) from 2001-2023



Source: Pension Integrity Project analysis of Utah Retirement Systems (URS) Valuation Reports

According to a study by the Wharton Pension Research Council, the reform impacted the system's unfunded liabilities, and the default choice largely drove the behaviors of new hires enrolled in the reformed choice plan.[9] Recording results in 2013, roughly 60% of members hired after the 2011 reform defaulted into the risk-balanced pension plan, with 22% actively choosing the reformed pension and the remaining 20% opting for the DC plan. The study makes it clear that default settings (in this case, a default directing employees who have not made an active selection to the pension) have a major impact on employees' decisions. If a policymaker is building a choice plan, then the default setting will be extremely meaningful.

Another study of Utah's pension reform showed similar results. Shortly after Utah implemented the reform, a study by Richard Evans and Kerk Phillips simulated the 2011 reform and its impact on the plan's long-term solvency.[10] The study looked at the currently active employees and projected new employees as if they had gone into the legacy pension plan with the now-replaced benefits and contributions. The study found that without reform, there was about a

9 Robert Clark et al, "Lessons for Public Pensions from Utah's Move to Pension Choice," *Journal of Pension Economics & Finance* 15 (2015). 285-310.

10 Richard W Evans and Kerk Phillips, "Simulating Utah State Pension Reform." *Brigham Young University Macroeconomics and Computational Laboratory Working Paper Series* No. 2012-01 (2012).

50% chance of URS insolvency by 2030. However, with the 2011 reform applied, those odds dropped dramatically to 10%.

The results of the two studies on Utah's introduction of a DC option—along with reform on the existing retirement plan—show that the change reduced the chances of insolvency without mass worker attrition. This and the continued success in improving URS' funding demonstrate the positive outcomes a choice plan can provide for government sponsors of pensions.

PART 3 Components of a Successful DC Choice Plan

Key to the success of a choice-based retirement system is its ability to provide quality options that are attractive and useful to its members and employers. That means that DB options should be structured to provide benefits in a sustainable and affordable way.[11] The DC option also needs to be well-structured to meet the needs of public workers.[12] A poorly executed or structured DC plan will not serve its purpose and will not be a valuable option to its members. Furthermore, it is unlikely to draw many members in an environment of new workers making a choice between multiple options.

3.1 Establishing Specific Objectives

Before covering how to properly structure and manage a DC-choice plan, a preliminary discussion is warranted on the role of stated objectives. Many public retirement plans have objectives stated in plan materials, or even set explicitly in government statute. These objectives serve as valuable touchstones to ensure that structures and policies are working to achieve a plan's stated goals. While many public retirement plans have stated objectives for the system, objectives specific to a DC plan are often not given. Since DC plans operate with goals and expectations that differ quite significantly from DB plans, it makes sense to establish entirely specific objectives for each side of the DB / DC choice plan. Clear goals and objectives can serve as a north star for DC choice plans, which informs policymakers of what success looks like for these plans and guides their decisions to meet those goals.

3.2 Appropriate Plan Structure

A 2023 Stanford study found that 89% of public employees were willing to switch from a defined benefit plan to a defined contribution plan, provided that an appropriate employer

[11] Ryan Frost, "Defined Benefit Plans: Best Practices in Incorporating Risk Sharing." Reason Foundation, 2021. www.reason.org/policy-brief/best-practices-in-incorporating-risk-sharing-into-defined-benefit-pension-plans/ (30 August 2024).

[12] Richard Hiller, Raheem Williams, and Leonard Gilroy, "Defined Contribution Plans: Best Practices in Design and Utilization." Reason Foundation, 2021. www.reason.org/policy-brief/best-practices-in-the-design-and-utilization-of-public-sector-defined-contribution-plans/ (30 August 2024).

contribution rate was offered.[13] Adequate employer contributions are critical in making DC plans a viable alternative to traditional DB, and valid, considering that market risk is transferred from the employer to the employee. There are several components of an optional DC plan that will determine how well it achieves the goal of providing an attractive and valuable retirement benefit to public workers. The first thing to consider is how the DC plan is structured, meaning the specifics of the actual benefit.

3.2.1 Adequate Contributions

The purpose of every retirement plan is to eventually provide enough income after a worker retires so they can maintain their standard of living. This is generally measured as a percentage of the individual's pre-retirement income. Different plans may have different replacement targets, but the general rule commonly recommended by financial experts is that a person save 10%-15% of their annual income for retirement if they are participating in Social Security and 18%-25% if they are not.[14] This gives a clear target for what a DC plan should provide if it is to be a valuable and competitive option.

How that total contribution is shared between the employee and the employer is ultimately the decision of government policymakers and plan administrators, but this also plays a significant role in how effective a DC choice plan will be. Some systems establish equal contributions from public employers and their members. Some systems choose to have one side of the employer/employee relationship cover a higher share of annual contributions.

In DC Choice plans, these selections must consider the alternate DB option. If a new member is choosing between two retirement plan options, the amount that will come out of their paycheck for each option is obviously a factor. Some DC Choice plans aim to match contributions to their DB counterpart, meaning employees will see the same amount deducted from their paycheck for either option. For example, in the North Dakota Public Employee Retirement System (PERS)—which will discontinue being a choice plan in 2025 with the DB portion closing to new members—regardless of which plan is chosen (DC or DB), there is always a 7% employee contribution rate and a 7.12% employer contribution rate. The distribution of funds and subsequent benefits will vary, but it gives balance to the employee, knowing that their contribution rates will stay the same between plans.

---

[13] Oliver Giesecke and Joshua D. Rauh, "How Much Do Public Employees Value Defined Benefit versus Defined Contribution Retirement Benefits?." Stanford University Graduate School of Business Research Paper No. 4308471, 2023. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4308471

[14] Jeanette Beebe, "How Much Should I Contribute to My 401(k)?" *Investopedia.com*, Investopedia, 28 August 2024. www.investopedia.com/articles/retirement/082716/your-401k-whats-ideal-contribution.asp (accessed 30 August 2024).

A new employee has more than just contributions to consider when choosing their retirement in a choice plan. The employee should weigh the pros and cons of each option against their particular situation and decide which is right for them. For example, a newly hired Utah employee would consider these factors.[15]

DB Option	DC Option
Stable, monthly retirement income	Flexibility to manage and withdraw on your own terms
Guaranteed benefit	No guaranteed benefit; potential for higher or lower benefit
Employee can continue to earn service credit if they continue to work for any state government employer	Once vested, if employee changes employment they can transfer their money if that employer offers a 401(k)

3.2.2 Potential Problems in Equal Rates Between DC and DB Plans—Florida Retirement System (FRS)

If policymakers want both DB and DC options to have the same contribution requirements, they should avoid certain policies. While it can make sense to equalize contributions for employees who are choosing between DB and DC options, applying this same policy to employer payments can lead to insufficient total contributions. This problem arises because DB plans work very differently from DC plans. Pension plans rely on actuarial estimates of compounding asset returns to fulfill promised retirement benefits, which can result in contribution rates that would not be appropriate if applied to a defined contribution plan. Over the last two decades, real experience diverging from actuarial assumptions on investment returns and demographic factors has generated significant funding shortfalls in pensions, placing a burden on government employers to come up with extra funds. With individual employees bearing any potential future funding burden in DC plans, it is usually appropriate to establish a contribution schedule that involves less risk of insufficient savings.

Wanting equal contribution rates across the board led to insufficient total contributions in the Florida Retirement System (FRS), which initially set its DC contribution rates to match those of the existing DB plan. This was a bad policy for two reasons. First, it failed to recognize that DB plans have different priorities and function differently than DC plans. Second, as the DB plan accrued unfunded liabilities over the past two decades, this necessitated much higher contributions from the state. While the state had to increase its payments to adjust to pension cost estimates that ended up being much higher than expected, the employer contributions for

15 "Your Choice: An Introduction to Your Retirement Benefit Options," *urs.org*, URS. www.urs.org/documents/byfilename/%7CPublic%20Web%20Documents%7CURS%7CDB%7CTier2%7CChoose_PE%7C%7Capplication%7Cpdf/ (accessed 10 September 2024).

the DC plan have remained so low that the plan's ability to provide a secure retirement was in question.

In their effort to reduce unpredictable runaway costs with a default DC plan, Florida policymakers anchored to a woefully low contribution rate that does not make sense for a well-structured plan. Fortunately, experts identified this shortcoming and employers promptly corrected with increased employer contributions into the state's DC plan. Now, Florida's Investment Plan has adequate contributions going into each member's account, and employees are no longer at risk of saving too little for a comfortable retirement.[16] While there are justifications for using equal employee rates between DB and DC options, policymakers should be wary of committing to equal employer rates.

3.2.3 Uneven Rates Between DC and DB Plans—Michigan State Employee Retirement System (MSERS)

Another approach in setting a contribution policy is to make the DC plan an option that requires a lower contribution when compared to the DB plan. This allows new workers to select a plan that provides more take-home income flexibility. For example, in the Michigan State Employee Retirement System (MSERS), the original DB plan had a member contribution rate of 4% and an employer contribution rate north of 24% (it varied due to shifting pension funding needs). In the current DC plan, the state contributes 4% of an employee's pay, while the employee can contribute their own 3% with an additional employer match (essentially making the employer contribution rate 7%). This represents significant cost savings for both the employee and the employer and a high level of flexibility. Employees can use this extra money to either put it in their own investment accounts or direct savings from their take-home pay.

Whether the optional DC plan has equal or smaller annual required contributions or whether the contributions are shared equally or unequally, *the least optimal policy is to have combined contributions that will not be enough to provide an adequate retirement income, meaning a combined contribution amount below 10% is unlikely to achieve the objectives of the retirement plan*. Inadequate contributions not only make a DC plan an unattractive option for new members, but they also prevent a plan from achieving its primary purpose of maintaining an acceptable quality of life for its members after retirement.

Contribution requirements play a role in how a new public worker selects their retirement option, so all the above should be weighed alongside a state or local government's needs. As long as adequate contributions are established in a DC Choice plan, various strategies can be used to fit each government's unique priorities.

---

[16] Zachary Christensen, "Increases to Contribution Rate Improve the Long-term Viability of Florida's Defined Contribution Plan," Reason Foundation, 2023. www.reason.org/commentary/increases-to-contribution-rate-improve-the-long-term-viability-of-floridas-defined-contribution-plan/ (30 August 2024).

3.2.4 Guaranteed Lifetime Income Options

Another consideration for developing an effective DC Choice plan is evaluating its ability to provide guaranteed lifetime income. Generally, this is perceived to be one of the weaknesses of a DC plan, but guaranteed lifetime income can still be achieved with annuities or guaranteed withdrawal benefits. Let's look at both cases:

1. **Annuities**: While the investment risk of a DC plan is ultimately shouldered by the employee, there are ways to turn a career of savings into a guaranteed lifetime income. This can be accomplished through purchasing an annuity. While many annuity products are available to anyone with a lump sum of retirement savings, public employers can realize advantages by providing their own annuity options—including a variety of fixed and variable products—through qualified vendors. This is a good way to ensure that DC options can still provide the security of guaranteed lifetime payments.

   Structuring effective annuity options into a DC plan that aligns with a planm's priorities helps to control the perceived downside to defined contribution plan, which improves its attractiveness and security to those making a choice between DC and DB.

2. **Guaranteed Withdrawal Benefits**: An option that can work in addition to an annuity is a guaranteed withdrawal benefit, in which a retiree withdraws a fixed percentage from their retirement savings every year, typically around 4%.[17] Offering these flexible options internally can help members take advantage of these products at competitive prices.

3.3 DC-Choice Execution

Building a retirement plan that ultimately leaves the pivotal decision of DB vs DC in the hands of the individual employee means that the employer needs to do what they can to educate and guide new members to make decisions that best fit their retirement needs. Beyond the general design of an optional DC plan, helpful policies can shape how options are presented and offered. These policies significantly affect a choice-based plan's success. The following subsections detail these initial policies to best serve new employees.

3.3.1 Educational Programs and Materials

Since a DC-choice plan structure empowers new employees to choose the type of retirement plan the best works for them, it is essential that they have a clear understanding of the choice

---

[17] Kagan, Julia. "What is the 4% Rule for Withdrawals in Retirement: How Much Can You Spend?" *Investopedia.com*, Investopedia, 11 June, 2024. www.investopedia.com/terms/f/four-percent-rule.asp (accessed 30 August 2024).

they are about to make. Public employers offering this choice have several methods they can use to equip new members with the information they need to make a well-informed decision.

Most government employers that offer a DC-choice plan give educational materials to new workers at the beginning of employment. These materials can vary in detail and presentation, but they should discuss the major factors of the decision simply in clear, layman language for the employee. Most new public employees have little familiarity with retirement options, and educational materials should reflect that by building a foundational understanding of retirement goals and risks. A common way to build this foundation is using introductory guides or handbooks. Some employers also offer presentations during orientation, or even direct individual consultation. Any combination of these methods can sufficiently empower new employees with the knowledge they need to make this critical decision. A few key elements to include are:

1. **Basic explanation of retirement plan structures**: Educational materials should first explain the differences between the DC plan and the other plan options that are available, summarizing the general differences in goals and strengths. Contribution rates for both employees and employers should be front and center for any of the optional plans types.
2. **Concepts of risk:** Materials should explain the various types of risk an employee will encounter with different plan types, including investment and longevity risks.
3. **Concepts of eligibility and portability**: New members need to understand the benefits of having a portable personal retirement account, and how the length of their employment could be a factor in eligibility requirements.
4. **Comparison of benefits for different employment situations**: It is important to also include a comparison of benefit accrual for multiple employment situations. That means multiple analyses of retirement accounts (or benefit accrual for DC plans) for workers in varying hiring age and years of service situations. If executed correctly, this comparison will convey how some members—namely those who remain employed for less than 20 years—could benefit more from a DC plan.

3.3.2 Selection Period

Due to tax requirements and general best practices in retirement plan structure, it is best to select a retirement option early on and stick with that selection through the end of one's employment. Public pension systems that give new members a choice between various options usually have a predetermined window in which a selection is permitted. Once the end of that period comes, any new members who have not made a selection typically have the choice made for them. To maintain good practices in long-term retirement fund security, it usually is not possible to switch between options after this initial selection period, and plans that do allow such a move should only do so in a way that preserves the financial stability of the plan at the expense of the member.

While all optional DC plans have a pre-determined selection period, they vary somewhat in the length of time plans give to new members. Some systems prefer to have their new employees either make a choice—or have the choice made for them, known as the default option—within the first few months. Colorado's Public Employees' Retirement Association (PERA), for example, only gives new workers 60 days to make their choice between DB and DC plans. Other systems, like the Utah Retirement Systems (URS), prefer to give new members as much as a year to weigh their options.

There is no best practice when it comes to this particular policy. Government policymakers simply need to find the selection period that best fits the administrative and funding needs of the plan, while also giving new members sufficient time to evaluate their options and make a good, educated choice tailored to their individual needs and risk tolerance.

3.3.3 Setting Default Options

Any choice-based decision offered to individuals will be highly influenced by the preselected option, also known as the default. Public pension plans that offer an optional DC plan usually give new workers a set amount of time to make their decision before they are automatically defaulted into either a DB or DC option.

Studies have demonstrated the power of defaults in shaping the retirement choices of individuals.[18] When it comes to decisions on retirement options, most employees generally follow "the path of least resistance," meaning they tend to make the selection that requires the least amount of effort. While it is very important to offer the option of choice between these two plans styles, most new members will end up in whatever is set as the default. Policymakers should recognize that defaults are highly influential in the retirement choices that will be made, and they should set defaults in ways that promote the choice that makes sense for the majority of workers.

According to its most recent employment data, Utah Retirement Systems (URS) had hired 124,624 employees since 2011, of which roughly 55% still remain. Of the remaining employees (and excluding those still within a year of being hired and not yet making a selection) about 78% were in the hybrid plan and 22% in the DC.[19] URS defaults new workers into the reformed DB plan (they call it the "hybrid plan"), and so having a 78% enrollment rate into that option is consistent with the idea that the default option is, by and large, what employees will favor.

---

[18] James J Choi, David Laibson, Brigitte C. Madrian and Andrew Metrick, "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance," *Tax Policy and the Economy*. Vol. 16. (2002). pp. 67–113.

[19] "URS Tier 2 Elections," Utah Retirement Systems, June 2024. https://newsroom.urs.org/tier-2-elections (accessed 30 August 2024).

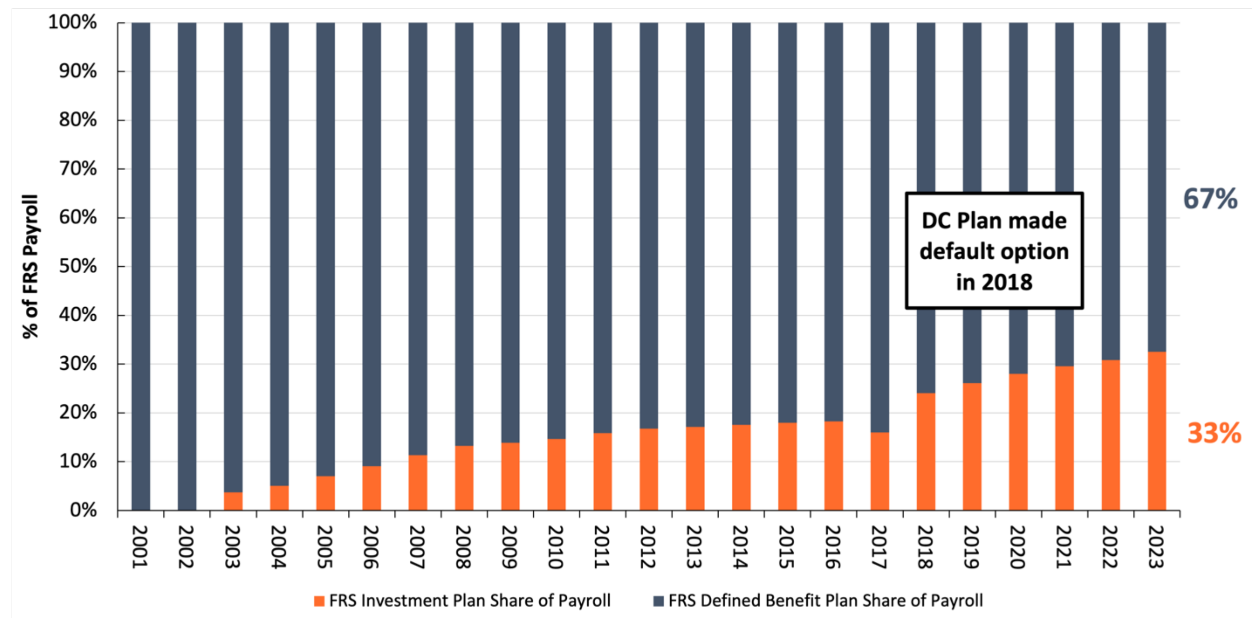
3.3.4 Impact of Defaults on Membership—Florida Retirement System (FRS)

The default option used in a choice-based retirement system is extremely influential on membership shares between multiple types of plans. Any change to a default will only affect new workers as they flow into a system, so the difference in membership shares will start small but eventually shift drastically. Due to a 2018 reform, the Florida Retirement System (FRS) is an excellent case study for the effect that defaults actually have on shares between two parallel plans.

In 2018, legislation from the previous year (Senate Bill 7022) went into effect for new members of FRS. The reform switched the default from the DB plan to the DC plan (known as the FRS Investment Plan) for most classes of incoming members. This reform created a unique opportunity to study the actual impact that defaults have on membership and payroll shares.

Reason analysis of total plan payroll shares reported by FRS going back to the introduction of the Investment Plan suggests that the default switch had an immediate impact (Figure 5). The share of total member payroll in the DC plan grew in the decade before the change but plateaued under 18%. After the DC plan became the default in 2018, there was a significant increase in the percentage of members in that plan, bringing that share to 33% in the last reported year.

Figure 5. Payroll split between DC and DB plans over time in the Florida Retirement System (FRS)



Source: Pension Integrity Project analysis of FRS CAFR reports

Note that—due to these being the only numbers available in official reports—these figures are the total share of all members' payroll, meaning all new and legacy members are grouped

together. Consequently, the effect of the default switch impacts only a small portion of the displayed population. The fact that the result is still quite evident among the combined group of members suggests that the DC default is having a large impact on new members. This impact will continue to grow as post-2018 members take a larger share of the total membership pool.

Essentially, the default policy is left to the discretion of policymakers. While setting this particular policy, they should make the decision that best serves the purpose of the retirement system—that is, it should maximize the retirement security of its members.

If they believe a DB plan will be a better fit for their type of employee—for example, they have a high number of employees who remain for a full career—they can make that the default. If they find that most employees are not staying for a full career or are not remaining long enough to take advantage of the prolonged benefit structure of a DB plan, they may want to set the optional DC plan as the default. The idea is to understand that defaults will determine the retirement choices for most new members, so it is important to identify the choices that work best for most workers and set that as the automatic selection for those who opt out of deciding for themselves.

PART 4 Conclusion

Call the DC Choice option the “modern option”, as it can be attractive to younger workers, helping govt employers compete for younger labor, and/or…

Discuss how unfunded liabilities, caused by reliance on DB plans alone, should be a relic of the past, and how govt employers should gravitate toward DC plans to help clear their debts, and/or

Discuss the dilemma of the golden handcuffs and how DB plans, with all the best intentions, can lead to unmotivated employees who feel locked into jobs they no longer enjoy. DC plans, by providing choice, offer employees more freedom in their work lives, which is increasingly of value to younger workers.

As the modern workforce becomes more mobile and governments contend with growing risks and costs associated with defined benefit plans, it has become increasingly prudent to offer multiple retirement options to public workers. A DC choice plan is a modernized approach that offers more flexibility than a standalone DB plan can to public workers. A choice between two well-structured retirement options empowers new employees to select the plan that best fits their unique goals and expectations for their career and post-employment life. The expansion of attractive retirement options can only improve a government’s ability to serve and attract young workers.

State and local governments expanding on their retirement options can serve up better benefits to employees, and in doing this can even slow growing costs caused by unfunded

pension liabilities. Ideally, policymakers should pair a well-structured DC option with a modernized (or reformed) DB option that is structured to manage employer exposure to large unexpected costs. This pairing better fulfills the objective of securing adequate employee retirement while not imposing unnecessary costs on taxpayers.

Offering an alternative to the traditional DB plan also addresses growing concerns with unmotivated and disassociated employees.[20] While the intention of DB pensions is to incentivize sticking around until retirement, this feature has increasingly become more of a handcuff to a workforce that prefers to move around more frequently from one job to another. Policymakers should ask themselves if they want employees that would prefer to be somewhere else but feel locked into their current position by benefits gated behind tenure requirements.

The expansion of choice (offering an optional alternative DC plan) is an effective solution to this challenge. It can empower public employees who want to work in a government position, but do not want to get locked into a path where they will be required to work an entire career in the same place to take advantage of the retirement portion of their compensation.

DC choice plans have enormous upsides both for the employee and employer. Different workers will prefer different retirement options, and choice is key to that. However, the success of these plans relies on their design. Examples also show that plan design can go poorly if priorities are unclear or unrealized. With a clear understanding of the purpose of these elements, policymakers can structure a DC choice plan that fits the particular needs and objectives of their retirement system and offer a retirement system that can serve a much wider variety of individuals.

---

[20] Jen Sidorova, "More Portable Retirement Plans Would Help Public Employers Attract and Keep Workers," Reason Foundation, 2022. www.https://reason.org/commentary/what-can-public-employers-do-in-response-to-the-great-resignation/ (10 September 2024).

ABOUT THE AUTHOR

Zachary Christensen is a Managing Director of Reason Foundation's Pension Integrity Project.

Christensen’s work with Reason's Pension Integrity Project aims to promote solvent, sustainable retirement systems that provide retirement security for government workers while reducing long term costs for taxpayers and employees. Zachary and his team provide education, reform policy options, and actuarial analysis for policymakers and stakeholders to help them design reform proposals that are practical and viable.

Christensen has contributed to in-depth solvency analyses of state and local government pensions all over the country, including Colorado, Arizona, Florida, Alaska, Oklahoma, Ohio, Texas, and Michigan.

Christensen's work has been published in the Los Angeles Daily News, Orange County Register, NJ.com, Colorado Politics, The Bond Buyer, Financial Times, and many other publications. He has also been featured in the Carolina Journal and the Michigan Capitol Confidential. His research has been published by the Hoover Institution, The Platte Institute, Texas Public Policy Foundation, and Rio Grande Foundation.

Prior to joining Reason Foundation, Christensen was a pension finance analyst at Stanford University’s Hoover Institution, where he worked on widely-cited research on the funding status and accounting methods for public sector retirement systems.

Christensen holds an M.S. in Public Policy from Pepperdine University and a B.S. in Political Science from Brigham Young University.