Public Pensions Must Move to 401(k) Plans

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New idea? Michigan ended defined-benefit plans (i.e., pensions) for new state workers back in 1997. Today, 49 percent of Michigan state workers are in defined-contribution plans, i.e., 401(k). Right-wing attack on government workers? The District of Columbia has used 401(k) plans since 1987.

Today, government workers can retire young and be retired longer than they worked. Their contributions account for roughly 8 percent of the estimated total pension payout they will get. As a result, three of Ohio's five government pensions don't meet their 30-year funding requirement.

Unlike Illinois and New Jersey, which used pensions contributions for other purposes, Ohio fully funded pensions every year. Nevertheless, Ohio's pensions cannot meet their obligations.

The state legislature is considering changes ranging from upping the retirement age above 52 (48 for safety workers) to changing the pension formula (from the average of the three highest years to the average of the five highest) to increasing employee contributions. These are positive steps, but none ensure that taxpayers won't have to bail out the pensions someday.

If taxpayers want security against a bailout, we must move new government workers to 401(k) plans and reform pensions for existing workers to reflect the norms for the private sector. We'll save $6 billion and still do right by our workers.

A move to 401(k) plans for new workers raises two issues: First, like any Ponzi scheme, those workers already in the system need the contributions of future workers to fund their pensions. These pyramids always collapse, and those last in always get left holding an empty bag. New workers and taxpayers shouldn't be exposed to such risk.

The reality is the private sector moved away from pensions, making them largely a creature of government, because guaranteed large annual payouts for pensioners' lives make predicting actual liabilities highly speculative and costly.

Next, the pensions point to the low average size of 401(k) plans as proof that such plans don't adequately provide enough funds for retirement. Of course, if workers fail to maximize payments to their 401(k) during their careers, they will not get the full benefits of employer matches and the magic of compounding interest.

A conservative model of a government worker shows the power of a 401(k) plan, if properly funded. By maintaining the 10 percent employee contribution and adding a 7.1 percent taxpayer contribution (the 4 percent average employer contribution in Ohio's private sector plus half the 6.2 percent employer Social Security payment), government workers could retire at age 65 with sizable nest eggs. Assuming just a 5 percent annual return, the 401(k) would total $1,539,659, or nearly $77,000 per year for 20 years (assuming no more growth).

The problem with transitioning from pensions to a 401(k) is the "Ponzi" cost of funding the pensions of existing workers without the contributions from new workers. Here are two ways to minimize the Ponzi cost.

First, allow workers to leave government whenever they want, but don't allow access to their pensions until age 62 for those with 25 years of service, 65 for those with 15-24 years, and 67 for those with 1-14 years. These figures track the eligibility for Social Security and a retirement age reflective of longer life expectancies. It also means they can enroll in Medicare, thereby reducing the need for pension-provided health care.

Some public-safety workers won't be able to physically perform into their 60s. That limitation also exists for private-sector Ohioans in physically challenging jobs. These workers can do what their private-sector peers do and find another, less physically demanding job to do until they can tap their pensions.

Next, gradually adjust the pension formula for existing workers in a way that doesn't reduce the expected yearly pension for workers close to retirement too much, but increasingly lowers the amount for workers farther from retirement. For example, increase the number of years used to get an average in the pension formula - five years for workers close to retirement and more years for fewer years of service until a career average is achieved.

Because of the nest eggs available with a 401(k), newer current workers may decide they, too, want to move to 401(k) plans. We should let them.

The reality may be that, even with big reforms, the Ponzi component will need additional funding. Rather than perpetuating a bad system, if an infusion of revenue via a temporary tax increase would fully fund the end of the gold-plated government pension system, perhaps even we'd support it. But, first make the big reforms and then we'll figure out how big the Ponzi cost really is.

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