



GRS RESEARCH MEMORANDUM

RE: List of Advantages and Disadvantages for DB and DC Plans
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There are many advantages and disadvantages to both defined benefit and defined contribution plans. In reviewing the following list, keep in mind that what may appear as an advantage to one person may appear as a disadvantage to another.

Defined Benefit Plan

Advantages

- Provides guaranteed lifetime income to retirees. No retirees outlive a defined benefit retirement annuity.
- Per dollar of benefit paid, it is less expensive to provide benefits through a defined benefit plan than through a defined contribution plan.¹
- Some governmental employees are not covered by Social Security. In these cases, a defined benefit plan offers irreplaceable financial security.
- Provides more income for career employees. Motivates employees to continue in service.
- Provides a benefit that bears an easily understandable relationship to working pay just before retirement.
- Automatically provides inflation protection during the working career.
- Outside service credit may be recognized (out-of-system service, service before plan inception, military service, etc.).
- Cost-of-living protection after retirement may be provided through automatic percentage increases, ad hoc increases, etc.
- Total investment management fees are typically lower than in defined contribution plans.

¹ Individuals in defined contribution plans need to invest more conservatively as they grow older and accumulate assets to finance benefits over their longest expected lifetime. Defined benefit plans do not have to alter their investment mix over time and can spread the risks of mortality over their members' lifetimes. Consequently, per dollar of benefit paid, a defined benefit approach is generally less expensive than a defined contribution approach.

- The employer bears the financial risks.

Disadvantages

- Provides less income for non-career employees.
- Most DB plans were not designed with portability in mind. Hence, benefits are often not as portable as defined contribution benefits, although recent changes in federal laws have improved defined benefit plan portability somewhat.
- Cost of the plan will fluctuate from year to year as a result of plan experience being different from actuarial projections.
- Difficult for employees to understand how much the employer is contributing on their behalf.
- Usually more complicated to administer.

Defined Contribution Plan

Advantages

- Contribution amount is easily determined, easy to understand and usually constant from year to year, in the absence of benefit changes.
- Provides more income for non-career employees.
- Account balances may be transferred to a terminating employee's next retirement plan, and hence the plans are usually more portable.
- Contributions are allocated to individual accounts. Employees can easily identify a specific dollar amount that is earmarked just for them.
- Pension costs for service rendered to date are always fully funded.
- Cost of administration is generally less than for a defined benefit plan.
- Opportunity for higher benefits if financial experience is superior.

Disadvantages

- Employee bears the financial risk of outliving accumulated assets. Half of all retirees will outlive the average life expectancy, in many cases by decades. DC plan retirees rarely convert any of their assets to guaranteed lifetime income.
- Provides less income for career employees.
- Benefits may not bear any relationship to pre-retirement working pay.
- Per dollar of benefits paid, a defined contribution plan is more expensive than a defined benefit plan.
- Employee bears the financial risk of poor investment return. In particular a series of poor investment returns during the first few years of retirement can devastate the retiree's accumulated assets.
- During periods of extended inflation, individual account accumulations tend not to produce benefits that have kept pace with increases in the cost of living. Even though salaries, related contributions and investment income would be increasing, the increase would generally not be adequate to offset the disproportionately lower salaries, contributions and investment earnings of earlier years.
- Loss of the financial security that accompanies regular monthly retirement income, particularly for employees who are not covered by Social Security.
- While generally alleged as having the advantage of portability, evidence suggests that short-term employees who terminate prior to retirement eligibility will take a lump sum distribution and use the money for other than savings toward retirement.
- Retirees are more likely to take a lump-sum benefit than a periodic payment for life.
- Outside service credit is not easily recognized.
- Does not motivate employees to continue in service to the extent that a defined benefit plan provides that motivation.
- Lower overall benefits may be available, if individual account balances are invested too "conservatively."

Generally, the question should not be "Which is better, a defined benefit plan or a defined contribution plan?" Instead, retirement benefits should be viewed in total, including those from Social Security, defined benefit plans, defined contribution plans, and deferred compensation arrangements. The question should be "Are these benefits sufficient, in total, to provide retirement security?"