Pensions Vs. 401K’s: Why you should Care that Pensions are Going Extinct

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Today’s Retirement Reality

Most twenty-somethings have never and (unfortunately) probably will never sniff the sweet security provided by a pension plan. So what are these mysterious things called pensions that many of our parents and grandparents lean on in their retirement? Why are they disappearing? And what are our chances of ever getting one? This is an essential issue for our generation, and I encourage you to read on and actively lobby your employer should you see fit. If you want change, it has to start with someone. Why not you?

1. Defined Contribution Plan

A defined contribution plan is a type of pension where an employee, employer, or both contribute funds to an employees retirement plan. 401(k)’s are defined contribution plans. These plans are dependent on the returns of the investments that are chosen within them.

2. Defined Benefit Plans

A defined benefit plan is what most of us commonly refer to as a ‘pension’. These plans offer guaranteed automatic payouts in retirement based on a formula that usually takes into account your salary and years of service. The longer you work and the more you make, the higher your automatic payouts. Most employers offered defined benefit plans at one point. Social Security is a type of defined benefit plan.

The History of the Pension

For generations, pensions were the retirement plan standard for just about every employer. This may be hard to believe, but it wasn’t until the early 1980’s that 401(k)’s even existed. Ironically, 401(k)’s were originally added to the IRS code as a way for companies to offer additional retirement benefits to high ranking executives, above and beyond their defined pensions. This didn’t last long.

Over time, most employers have made the shift from defined benefit pensions to 401(k)’s. 401(k)’s were sold as the fresh new thing, giving employees all of the power to choose their own investments. In reality, they were often times a low to modest cost savings over their defined benefit counterparts. The combination of the appeal to the American individualistic ambition and cost cutting possibilities were the perfect storm to sell 401(k)’s over their elder relative.

A Pension Story that Hits Home

My father retires on May 1st. He put in 36 years with the State of Michigan. At one point in the early 90's, the State offered him a 401(k) cash exchange for the existing value of his defined benefit pension. He turned it down. It was the wisest decision he ever made. In May, he will begin to receive over $3,000 per month in pension benefits **above and beyond** his living expenses. And this doesn't even include Social Security, or the 401(k) that he started from scratch! He's set for life and has the security in knowing that his pension benefits are safe and guaranteed.

Could he have had a bigger payout if he switched? Maybe, but most likely not. The stock market hasn't advanced in the last 12 years, after all. Either way, I'm almost positive that he's been able to sleep a whole lot easier back then and he certainly is now.

Eliminating the Security of Pensions

Unfortunately, stories like my father's are disappearing. Not only has the guaranteed security of pensions been attacked, but I fear that we've hit a critical point of no return. 401(k)'s are now so ingrained in our culture that pensions are viewed as a Jurassic, boring old benefit of yesteryear.

To add insult to injury, employers have not only changed the plans, but they've scaled back the benefits as well. Many of my peers have 401(k)'s that only offer a 2 or 3% max 401K match. How can anyone retire on that, especially in light of recent market turmoil?? That kind of limited benefit is an absolute tragedy.

Even Social Security, a type of defined benefit pension, is under attack. Had the Bush administration gotten its wish, it would have shifted to private management as well. Right before one of the biggest drops in stock market history.

An Increase in Employee Turnover Without Pensions

Another unintended consequence of this benefit switch is employee turnover. At present, the employer turnover rate in the U.S. is over 40% per year! It didn't use to be that way. Defined benefits offered employees a strong incentive to stay around and be loyal to their employers. How many baby boomers do you know that have been at their job for 20, 30, or 40 years? Sure, there has been a cultural shift away from loyalty in the workplace, but with the disappearance of pensions, is there any wonder why?

Why should employers care? They were able to cut some costs, after all, and that's good, right? Here's why they should care – it's been estimated that employee attrition costs 12 to 18 month's salary for each leaving manager or professional, and 4 to 6 months' pay for each leaving clerical or hourly employee. When employees don't stick around for 3 years, these costs start to add up.

Instead of a loyal, efficient, 35 year lifer, you're looking at 13 employees who come and leave as soon as they get the skills they wanted to grow, or as soon as they get bored. They have no incentive to stay! So are employers really saving money? I'd argue that they are not. They have cut off their nose to spite their face. And they are paying enormous costs to do so.

You want a Pension?

Lobby your employer. Get others to join your cause. Help your employer research the costs of running such a plan, and the potential savings benefits over 401(k)'s that come from lower employee turnover. Appeal to them on their level – they want to keep good employees, and they want to lower costs that come from having to recruit, hire, train, and get new employees up to snuff. Work with them, not against them. Any research that you can provide regarding potential cost and talent savings is going to help your cause.