Many policymakers are exploring reforms to pension plans for state and local government employees, such as shifting newly hired employees to defined contribution or cash balance plans. However, some have argued that such conversions may entail “transition costs” that make reforms prohibitively costly. If successful pension reform is to be enacted, policymakers should understand what transition costs do and do not mean for terminated pension plans.

A new study for the Mercatus Center at George Mason University explores investment-based transition costs and calculates optimal investment portfolios for pension plans, both those that remain open to new participants and those that have been closed. This is the first policy study of its kind to analyze investment-based transition costs for public-sector pension plans. The difference in portfolio allocations between open and closed pensions is small and takes place only over long periods. The study concludes that claims of large transition costs have been greatly exaggerated.

To read the study in its entirety and learn more about its author, Andrew G. Biggs, see “Investment-Based Transition Costs Associated with Closing a Public Defined Benefit Pension Plan.”

SUMMARY

Funding levels for state and local government pension plans have been an ongoing issue since the onset of the Great Recession. Funding shortfalls nationwide range from approximately $1 trillion to more than $4 trillion. Annual required contributions to public plans have more than doubled over the past decade, imposing a financial strain that many governments have been unable to bear. Some governments have failed to make required contributions, slowing the recovery from the financial hit taken in the wake of the economic downturn. In response, policymakers are considering a range of options, including replacing defined benefit plans with defined contribution or cash balance plans.

Some opponents of such reforms claim that closing defined benefit plans would actually increase costs because of so-called transition costs. They argue that a closed pension plan must shift to a
much less risky, lower-returning investment portfolio. Lower returns would then require higher contributions from plan sponsors. Such arguments have been used to hold off reforms in a number of areas, but the fears they represent are ungrounded.

KEY FINDINGS

Simple qualitative analysis of the claims made about investment-based transition costs leads to the following findings:

- **Public pension plans should invest significantly more conservatively than most plans currently do.** Retirement systems offering guaranteed benefits should not hold a portfolio composed mostly of risky assets. Some public plans hold up to twice the levels of risky assets that financial advisors would recommend for individual investors. For example, in order for the Pennsylvania State Employees’ Retirement System to fully fund future benefits, an optimal portfolio would consist of roughly 15 percent equities and 85 percent bonds. By contrast, the current portfolio includes roughly 15 percent bonds and 6 percent cash equivalents. The remainder of the portfolio is held in equities and other risky assets such as private equity and real estate.

- **Pension plans must account for risk.** Warnings about high investment-based transition costs arise from a philosophical standpoint that public pensions, at least when open to new participants, do not need to account for the risk of their investments. But public pensions should account for risk and, when they do, the appropriate portfolio for an open pension plan is not substantially more risky than one for a closed plan.

- **Transition costs will be much smaller than claimed.** Closing a defined benefit pension plan does generate investment-related transition costs: as the plan’s liabilities become progressively less “stock-like” and more “bond-like,” the optimal portfolio shifts from stocks toward bonds. But these transition costs are far smaller than many critics believe because even the liabilities for an ongoing pension plan are largely bond-like and thus the appropriate portfolio for an open plan should not be stock-heavy.

The absence of substantial transition costs does not imply that defined benefit pension sponsors should shift to defined cost, cash balance, or hybrid plans. There are many factors that should influence the choice of reform strategy. Transition costs, however, should not be one of the top considerations.

CONCLUSION

Converting defined benefit pensions for government employees to defined cost, cash balance, or hybrid plans would not create significant new costs for the public. While converting public pension plans won’t make their unfunded liabilities go away, it will prevent the liabilities from getting worse. Arguments for maintaining failing pension systems due to perceived transition costs are not based on empirical reality.