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RESEARCH SUMMARY

ARE THERE TRANSITION COSTS TO CLOSING A PUBLIC-EMPLOYEE RETIREMENT PLAN?

Defined-benefit pension plans for state and local government employees have imposed rising costs and financial risk on government budgets. In response, some reformers have proposed shifting newly hired public employees into defined-contribution plans similar to 401(k)s. But critics of this proposed reform have argued that closing a pension plan to new entrants would impose "transition costs" on plan sponsors as liabilities under the old defined-benefit plan are paid down.

A new study for the Mercatus Center at George Mason University explores how closing a pension plan to new entrants affects existing liabilities and whether there are significant costs imposed when transitioning to a defined-contribution, 401(k)-type plan. In fact, transition costs are very small, and they are more than offset by the reduction of newly accrued liabilities.

To read the study in its entirety and learn more about its author, Andrew G. Biggs, see "Are There Transition Costs to Closing a Public-Employee Retirement Plan?"

KEY FINDINGS

Closing a defined-benefit pension plan to new participants has two effects with regard to the plan's financing.

- Over time, the duration of the defined-benefit plan's liabilities shortens as participants grow older and younger employees are shifted to other plans. As a result, the plan's investment portfolio grows more conservative, and the portfolio's expected return declines.

- The value of the defined-benefit plan's overall liabilities also shrinks because newly hired employees participate in a defined-contribution plan where employer liabilities are not accumulated.

The second result dominates the first: The reduction in liabilities from shifting newly hired employees to a defined-contribution plan more than offsets the higher contributions required to

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fund the remaining defined-benefit plan liabilities as the participant population ages and the investment portfolio grows more conservative. Recently, the volatility of required government pension contributions has caused many state and local governments to fail to make full contributions, worsening the problem of underfunded public-employee plans.

A closer look at the data

- These conclusions are supported by data from the Oregon pension system that allowed the author to develop a baseline investment portfolio. Based on these data, the expected return and portfolio allocation of a pension plan after being closed to new entrants may be calculated. The effects of closing a defined-benefit plan to new entrants on the plan's investment portfolio are both very small and very gradual.

- Ten years following the closing of the plan to new entrants, the share of the portfolio held in equities would decline by less than one-tenth of a percentage point, and the expected return on the portfolio would decline by less than .01 percent.

- Thirty years after the plan is closed to new entrants, the stock shares would fall only from 32.16 percent to 31.20 percent. The expected return would decline by only .01 percent.

- By the 79th year following the closure of the plan, when very few participants are still receiving pensions, the assumed return on the plan's investment portfolio would experience only a 0.56 percentage point reduction from when the plan was open to new participants.

Issues with the valuation of public-sector pensions

The discussion of transition costs takes place within the larger debate surrounding the correct valuation of public-sector pensions. Most economists take serious issue with the accounting rules promulgated by the Governmental Accounting Standards Board (GASB). The GASB rules allow public plans to discount their liabilities using the assumed rate of return on the assets used to pay those liabilities. This valuation method creates a perverse incentive for public pensions to take on additional investment risk.

GASB accounting rules also discourage public plans from holding safer, less risky investments because the lower returns associated with safe assets would require the plans to report larger liabilities and thus increase their annual contribution. This result has added to the apprehension about transitioning to new plans, but it does not change the economic reality that the value of a liability cannot be changed by the funding strategy that an entity uses to pay that liability.

CONCLUSION

Claims of "transition costs" associated with closing a pension plan are mistakenly based upon changes in the plan's portfolio in isolation from the reduction in the plan's liabilities that causes the shift in portfolio allocation. Both economic theory and data from the Oregon Public Employees Retirement System show that these transition costs are minimal and usually will be offset by other savings. When viewed in totality, it becomes clear that closing a defined-benefit plan to new participants does not increase plan liabilities.