FAQ

NATIONAL INSTITUTE ON
Retirement Security
Reliable Research. Sensible Solutions.

ISSUE BRIEF: "Look Before You Leap: The Unintended Consequences of Pension Freezes"

What is a pension freeze?

An employer freezes a defined benefit (DB) pension plan when it limits the ability of employees to earn benefits in the plan. An employer may have the option to "hard freeze" a pension by ending benefit accruals for all employees or to "soft freeze" the plan only to newly hired employees. Private sector employers typically have some latitude in freezes while public employers typically are restricted to soft freezes.

What are the unintended consequences of a pension freeze?

The issue brief warns that freezing a DB plan can have serious and unanticipated impacts such as increased costs to employers (and, taxpayers in the case of public plans), reduced retirement benefits, or some combination thereof.

What are the key findings of the issue brief?

The research finds that freezing a DB plan and moving to an individual defined contribution (DC) plan can:

- Increase costs to employers and/or taxpayers due to higher costs of operating two plans, erosion of economic efficiencies, and front-loaded contribution requirements; and
- Further exacerbate retirement insecurity concerns, which in turn can hamper worker recruitment and retention effort, result in higher turnover rates, create labor shortages, increase training costs, and lower productivity levels.

These findings come at a time when deteriorating economic conditions have employers searching for ways to reduce costs, while workers are increasingly anxious about retirement insecurity.

Why would freezing a pension increase costs?

Freeze proposals can surface when employers – particularly state and local governments – are looking for ways to deal with shrinking budgets and tough economic conditions. However, a careful examination shows that freezing the plan will typically cause costs to *increase* significantly in the short run—not exactly the desired result for a state or municipality that is already in economic turmoil.

First, there is the simple fact that maintaining two plans is more costly than operating just one.

Second, employers that switch to DC plans will forgo the built-in economic efficiencies inherent in DB plans, and freezing a DB plan will actually undermine the economics of a frozen plan over time.

And third, freezing a DB plan can drive up costs because of accounting rules that govern public pension plans. These rules can cause an acceleration of required pension contributions in the wake of a freeze.

If a pension is frozen, can individual 401(k)-type DC plans replace the pension benefit?

While an employer can decrease its pension costs by changing the generosity of the DB benefits, doing so reduces retirement income. But, the harm to retirement security is more severe when a DB plan is frozen in favor of a switch to a DC scheme.

A good example is West Virginia. There, workers who were placed in a DC plan struggled to build up enough savings in their individual retirement accounts. The average DC account had a balance of only $41,478. Only 105 of the 1,767 teachers over age 60 had accumulated more than $100,000, which would provide only about $600 per month in retirement income. The most common reason cited by the teachers and school personnel for these “pitifully small” balances was unfamiliarity with investing. Concerned that insufficient retirement income would require some form of governmental assistance, West Virginia “unfroze” the DB plan to ensure adequate, secure retirement income.

What should policymakers do in light of these findings?

Policymakers should be aware that the trend in the private sector to freeze DB plans and move to DC plans is unfortunate and has had serious, negative ramifications for workers’ retirement security prospects. However, public sector employers can avoid the same regrettable results for their workforces by exercising caution, and allowing the facts to guide decision-making. Policy makers are wise to look before they leap because freezing DB plans and switching to DC plans can carry unintended consequences.

Time and again, states that have carefully studied the issue have concluded that, even in tough economic times, continuing to provide retirement benefits via cost-effective DB plans meets the joint interests of fiscal responsibility for employers/taxpayers and retirement security for employees.