Overview

The National Institute on Retirement Security has released a new research brief entitled, “Look Before You Leap: The Unintended Consequences of Pension Freezes.” The report warns that freezing a defined benefit (DB) plan can have serious and unanticipated impacts such as increased costs, reduced benefits, or some combination thereof. Additionally, the research indicates that caution is the watchword for decision makers – particularly state and local governments – grappling with fiscal challenges during the current economic turmoil.

Key Findings

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.

Anatomy of a Freeze

An employer freezes a 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.

According to the Government Accountability Office (GAO), nearly half of private sector DB pension plans are currently closed to new entrants. Although employers often establish a new DC plan after freezing a DB pension plan, researchers have found that the replacement DC plans typically offer much less generous benefits than the DB plans being frozen.

In contrast to the chill that has settled over private sector DB pensions, public sector plans still are faring well. Some 80 percent of public sector workers are still covered by a traditional pension, and, according to another GAO report, the majority of public sector pension plans are fiscally sound.
Higher Costs

Despite the health of public pension plans, freeze proposals can surface in an effort to save money for state and local governments facing 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.*

Increased Retirement Insecurity

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.

The recent experience in West Virginia is instructive. There, workers who were placed in a DC plan struggled to build up enough savings in their individual retirement accounts. The average DC account balance 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—such as increased retirement benefits, welfare or Medicaid—West Virginia “unfroze” the DB plan to ensure adequate, secure retirement income. And, reopening the DB plan is estimated to save the state $22 million.

Summary

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. The current economic turmoil has magnified this insecurity. 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.