Moving new employees to a defined contribution plan ***will not*** result in meaningfully higher costs for the legacy defined benefit system.

Steeply rising retirement costs and uncertainty about how high defined benefit pension costs might rise in the future have led many policymakers to consider adopting defined contribution plans, like private-sector 401(k)s. Opponents of reform have sought to derail these efforts by, among other things, claiming that any transition from status quo plans would result in significant, unforeseen costs. This memo briefly describes why these claims are inaccurate and provides additional background resources for readers who want to learn more.

Annual pension contributions are comprised of "normal cost," which is the cost of benefits earned by employees in a given year, and amortization cost, which is the cost to pay down any accumulated pension debt. Employees' annual contributions are used to pay for their own benefits (i.e., normal cost) and are not used to pay amortization cost. In fact, employees may always choose to withdraw their own contributions from the plan, often with interest, instead of receiving a monthly annuity check in retirement. Employers generally contribute some amount towards the normal cost of the pension plan and fully cover amortization payments.

The normal cost payments for new employees (employee plus employer) are used to fund the benefits earned by those employees. Those payments are in no way used to pay for the benefits of older employees, retirees, or to cover amortization costs. Since those normal cost payments are used solely to pay for the new benefits earned by new employees, moving those new employees and their normal cost payments to a defined contribution system would have no material financial impact on the legacy defined benefit system.

If new employees were placed in a defined contribution plan, the legacy defined benefit system would continue to be funded as it is today - by normal cost payments from participating members and their employers and by amortization payments, which are fully covered by the employer. Placing new employees in a defined contribution plan has no effect on either the real cost of benefits earned under the legacy system or the cost of paying off any funding shortfalls. Employers can continue to make amortization payments on the same schedule as a percentage of total payroll.

Public pension reform is arguably one of the most immediate and intractable financial problems facing all levels of government today. The underfunding of worker retirement benefits is irresponsible. Rising pension cost has placed undue political and budgetary pressure on workers' benefits, salaries, and even their jobs. Unfortunately, the next generation of public workers and taxpayers will be left to deal with this hefty fiscal burden unless we take action to fix the system.

Too often misguided transition cost claims frustrate reform efforts that would otherwise place governments on a more sustainable path. Policymakers should move beyond these misleading claims and adopt comprehensive reforms that better protect both workers and taxpayers.

Additional Resources

Arnold Foundation Policy Briefs
The Transition Cost Mirage
GASB Won't Let Me

Pension and Investments Magazine Op-ed
Transition Cost not a Bar to Pension Reform

Reason Foundation
The "Transition Costs" Myth

Testimony in Pennsylvania
Josh B. McGee
Andrew Biggs

Manhattan Institute
Defined-Contribution Pensions Are Cost-Effective