Dispelling the "Transition Costs" Myth: Simple Facts About How Defined-Benefit Pensions Are Funded

#1: Defined-benefit pension systems are not like Social Security. Pension plans are designed to be *prefunded.* This means that in any given year, a government managing a pension fund should be paying in enough to cover all of the benefits earned that same year.[1]

#2: Employee contributions to defined-benefit pension systems are *not* supposed to fund current retiree benefits. A common fear is that defined-benefit (DB) plans need new members—and their payments into the system—in order to keep the pension fund solvent. The belief is that closing the DB plan to new entrants will require higher payments from employees in the plan or from the government in order to fund current retiree benefits. However, this simply is not true. Because DB plans are supposed to be fully funded each year by employer and employee contributions plus investment earnings, active workers *do not* subsidize retirees. As the calculation for normal costs (*right*) shows, public employee pension systems are not Ponzi schemes.

#3: There is *no* legal requirement to increase debt payments during the transition to a defined-contribution (DC) pension system. The Governmental Accounting Standards Board (GASB) deals specifically with accounting for and reporting of pension benefits, not recommending an approach to funding as they have done in the past. As clarified by GASB, "[N]ew Statements mark a definitive separation of accounting and financial reporting from funding."[2]

Again, GASB establishes no *requirement*, legal or otherwise, to make any such change to debt payments. It is a policy choice independent of the transition to a DC pension system. This means that calling a change in debt repayment a "transition cost" ignores the fact that the government has a choice whether to do it or not, *and* that an increase in annual payments on existing debt in order to save on total payments over the long run is a "cost".

Understanding the Pension Funding Equation

There are two primary components to pension funding: (1) the annual cost to prefund pension liabilities, known as "normal cost"; and (2) the cost to pay off unfunded pension debt.

Normal Cost + Debt Payment =
Annual Required Contribution
to prefund accrued pension benefits

Normal Cost: Actuaries annually determine how much a government should save today to fully prefund accrued pension benefits that will be paid in the future. That amount is the "normal cost" needed today to grow over time and pay out benefits in the future. Employees typically contribute a fixed percentage of their pay toward normal cost. The government, considered the "employer," contributes the rest of normal cost.

If a government decided to transition toward a DC system, it could simply declare its DB plans closed to new members. Existing employees would stay in the DB plan and continue paying their share of normal cost, while the government would continue its annual contributions to normal cost as well. Over time, normal cost for the DB system would decline, as employees would retire and not be replaced in the DB system by new ones.

Debt Payments: If a pension plan has unfunded liabilities (measured as the value of a pension fund's assets relative to the promised benefits), actuaries project how much the government should pay each year over a certain time frame to completely pay off any pension debt. This constitutes an *amortized debt payment*.

During the phasing out of a DB plan, unfunded liabilities could grow—but only if the government did not pay the full actuarially determined ARC or if investment returns underperformed. Neither would be related to the "transition" to a DC plan.

Bottom Line: Phasing out a DB plan will *only* lower normal costs for the closed system. As long as the normal costs for the new DC plan are lower than the closed system, a DB to DC reform will not increase costs for a government.

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[1] This one-pager is a summary of the Reason Foundation policy brief "The 'Transition Costs' Myth" available at http://bit.ly/1yDqb0a.

[2] GASB'S New Pension Standards: Setting the Record Straight, http://bit.ly/1zPQgbA

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