THE ETHICS OF THE PENSION SWITCH: THE EFFECTS OF THE CHANGE FROM DEFINED BENEFIT TO DEFINED CONTRIBUTION PENSION PLANS

by

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DEFINED CONTRIBUTION

PENSION PLANS

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INTRODUCTION

Concern about the future of retirement security has steadily increased in the United States over the past decade, fueled by major changes in the retirement system and capital markets. One of the most prominent changes occurring is the switch from defined benefit pension plans to defined contribution pension plans, a major trend among United States corporations. The number of defined contribution plans providing the main source of employer-sponsored retirement income is increasing each year (Rappaport, Schaus, & Clymer, 2011). According to Towers Watson & Co. only thirty percent of Fortune 100 companies offered a defined benefit pension plan to salaried employees as of June 2012. That percentage is down from thirty-three percent in 2011, thirty-seven percent in 2010, and forty-three percent in 2009. In 1998, ninety percent of Fortune 100 companies offered defined benefit plans (Geisel, 2012). This shift is referred to as the "pension switch" in the title and throughout the paper.

The propositions and support included within this thesis focuses on this pension switch and the resulting effects on both employee and employer. Additionally, I will research and evaluate the ethics of corporate decisions regarding the pension switch based on ethical theories. To aid the reader in understanding the overall topic and the vocabulary used throughout, I will first define what a pension is and describe defined benefit (DB) and defined contribution (DC) pension plans.

A pension plan is a type of retirement plan in which an employee transfers part of his/her income stream toward retirement income. When an employer participates in the retirement plan, the employer makes contributions towards a pool of funds set aside for an employee's future benefits. There are two types of pension plans— 'defined benefit'

and 'defined contribution.' A defined benefit plan is a retirement plan funded and managed entirely by the employer, in which the employee may or may not contribute. At retirement, the employee is promised a specific payout amount that is calculated using a pre-determined formula. If the employee does not contribute to the plan, he/she does not bear any investment risk (risk that the investment will result in a loss) (*Personal Finance*). Even if the employee does contribute to the pension, the employer's responsibility of payment after retirement is a much more significant risk than the employee's minimal investment risk.

In contrast, a defined contribution plan is a retirement plan in which the employer contributes a specific amount to the employee's retirement fund while he/she is working. DC plans are funds owned and controlled completely by the employee. Common examples of DC plans are 401(k) and 403(b) plans. The employer is absolved of any additional responsibilities when the employee retires. With the DC plan, both the employer and employee may (since some employees choose not to match) contribute to the retirement fund; however, the employer contribution alone is very seldom enough to provide a comfortable retirement. The final pension amount is determined by the following factors: how much is invested, how fast the investment grows, and how many years the investment is able to grow (*Personal Finance*). There is no guarantee to the actual amount of money an employee will receive at retirement with the DC plan. The switch from DB to DC pension plans shifts the investment and longevity risks from employer to employee. The longevity risk refers to the risk of an employee outliving his/her retirement funds.

Over the past two decades, employers in nearly all industries have decided that DB pension plans and the responsibility associated with them are not sustainable and have switched to DC plans. Employer costs, volatility and unpredictability of cash contributions and accounting expenses, administrative burdens, and responsibility for uncertain obligations are among the various reasons why employers chose to make the switch. Employers complain of being the victims of a “perfect storm” of uncontrollably economic force to justify these changes- “an aging workforce, entitled retirees, a stock market debacle, and an outmoded pension system that cripples their chances of competing against pension-less competitors and companies overseas” (Schultz, 2011). The effects of new accounting rules implemented in 1987 were another motivator for employers making the switch. The new rules require employers to disclose the size of their pension obligation on their financial statements and show how pension debt affects income each quarter; by reducing pensions, firms reduced the liability on their books and generated paper gains (Schultz, 2011).

As more employees age and progress into their preretirement years with only a DC portfolio, their capability to manage the corresponding risks and live comfortably without a guaranteed monthly payment amount will have a growing impact on both employees and employers. The pension switch typically does not affect employees employed with the firm at the time of the switch, but only those that join the firm after the switch; instead of offering the new hires DB plans, they will only be offered DC plans. The options available to these employees for managing their risks include saving more, working longer, reducing consumption during retirement, working during retirement, and investing funds in less volatile assets. Although these options can be very

useful in reducing the risks of retirement, most involve a considerable adjustment to lifestyle (before and after retirement) and/or workforce contribution and have the potential to negatively impact the employer as well.

Throughout the remainder of the manuscript, I discuss the research question asked and review existing literature (almost exclusively academic articles and research) on the topic at hand related to three separately developed propositions. I will also discuss the research findings and note the implications of the research performed and final findings. The propositions within the thesis are:

1. Employers will overemphasize the positive aspects of defined contribution pension plans (relative to DB plans) to employees in order to gain their acceptance, not adequately indicating the potentially serious long-term effects resulting from the switch from defined benefit pension plans.
2. The switch from defined benefit to defined contribution pension plans will disrupt effective workforce succession, affecting younger generations of employees as well as retirees.
3. When the actions of companies that have switched, or are currently switching, from defined benefit to defined contribution pension plans are evaluated against prescribed ethical theories and models, their actions and the resulting effects may be deemed unethical.

To provide extensive support for the propositions within, I build and analyze and theories throughout the thesis as an extension of the literature review.

RESEARCH QUESTION

This thesis seeks to answer the following specific questions: 1) How does the switch from defined benefit pension plans to defined contribution pension plans affect both the employee and employer? and 2) When measured against prescribed ethical theories, are those effects deemed ethical or unethical? These questions are relevant because the switch from DB to DC pension plans is current, prevalent, and will affect most employees of large corporations. Not-for-profit and government employees will be affected as well as these organizations begin to make similar changes. Additionally, these questions are important because many large corporations making the pension switch do not adequately inform employees of all potential effects, both positive and negative, of the switch. The answers to these questions will allow both employers and employees to understand the pension switch and its effects and how the pension situation can be improved upon.

I provide answers to these questions through evidence within the three propositions below. First, I answer the question "What are the effects on employees?" in proposition one, in which I outline the current and long-term effects of the pension switch on employees in detail and offer support by two separate theories (*Social Influence Theory* and economics-based *Utility Maximization Theory*). I also answer this question in proposition two, in which I outline the effects of disrupted workforce succession (an effect of the pension switch) on young and old employees and provide support with two motivation theories (Frederick Herzberg's *Motivation-Hygiene Theory* and *The Engaged Performance Model*).

Second, I provide an answer to the question "What are the effects on employers?" throughout the first and second proposition. In the first proposition, I define how the pension switch affects employers in terms of managing retirement plans and a less-motivated workforce. In the second proposition, I define the effects of disrupted workforce succession on employers, including increased volatility in staffing needs and higher workforce costs. Lastly, I provide an answer to the question "Are the effects ethical?" in proposition three, in which I evaluate the actions of companies making the pension switch against two pre-existing ethical theories.

In completing this thesis and answering the questions above, I hope to learn about the following: the differences between a defined benefit and defined contribution pension plan, the employee responsibilities in planning for retirement with a DC pension plan, and the ethics of employer actions when evaluated against existing theories to determine if the results match my personal opinion. I have designed the propositions within so that I will learn all of these things and share them with the reader. I plan to learn all of these things (and more) by thoroughly researching many of the existing academic sources, analyzing the supporting theories, and consistently asking questions. As a student and future employee, it is important that I educate myself about the current retirement plans and changes occurring so that I can adequately prepare for a comfortable retirement in my future. I believe it is important that others educate themselves as well; thus, the reason I chose the specific research questions listed above.

LITERATURE REVIEW

Proposition One

The first proposition states: employers will overemphasize the positive aspects of defined contribution pension plans to employees in order to gain their acceptance, not adequately indicating the potentially serious long-term effects resulting from the switch from defined benefit pension plans. There are advantages of both defined benefit and defined contribution plans; however, employees lose many of the existing advantages of defined benefit plans in switching to defined contribution plans.

Advantages of defined contribution plans, that employers will likely overemphasize, include strong growth potential, immediate vesting, portability, and greater employee control over funds (Ferrara 2012). There is no doubt that these are real benefits; however, employers will likely put more emphasis on the potential benefits than on the potential costs of defined contribution plans when discussing them with employees. Strong growth potential stems from the fact that defined contribution plans include no limit on the benefits workers can receive as a result of strong investment performance (whereas most defined benefit plans inherently have limits); however, "strong potential" assumes that the employees are well educated and able to make sensible investment choices in regards to their DC plan. A plan's growth potential is dependent upon the employee's skill in managing their own investments, but the reality is that many employees do not have the same level of financial knowledge and investment skills required to build an effective retirement plan that the sponsors of defined benefit plans have (Rappaport, Schaus, and Clymer 2011); therefore, less-educated employees are at a major disadvantage. It is important to note that growth potential is also dependent

on the overall market's long-term average and level of risk one should take with pension assets— there is a limit to what investments will grow to regardless of who manages them.

The aspect of immediate vesting, meaning that employer contributions become full property of the worker upon payment, will also likely be overemphasized. Immediate vesting can occur because plan contributions are paid directly into individual employee accounts, which also leads to portability of funds. Workers can easily take their accumulated funds with them upon changing jobs. Portability and immediate vesting are severely limited by the common pool of benefits held under defined benefit plans, requiring long-term service (usually about ten years) to fully vest and accumulate funds (Ferrara 2012).

Lastly, greater employee control is the positive aspect most likely to be exaggerated by employers in discussing DC plans with employees. Retirement funds under DC plans are under the control of the employee in his/her own individual account; consequently, employees can apply the investment strategies, within the available options, that best suit personal needs and preferences. Most DC plans give only a few options of mutual funds to invest the DC assets in. Unlike a DB plan, in which a plan sponsor assumes the responsibility of managing investments, the individual employee has full responsibility and decision-making power for their own plan investments. Shifting this responsibility to the employee makes DC plans much easier for employers to manage, a major incentive for making the switch.

When employers choose to switch from DB plans to DC plans, employees are forced to accept a number of negative aspects associated with DC pension plans that do

not exist under DB plans. Although pension law exists to avoid such consquences, it is much like a “toothless dog”, according to Ellen Schultz. Pension law may sound scary, but it has no bite; employers have been fairly free to make self-interested decisions when it comes to pension management, which enables these negative aspects to exist. The most prominent negative aspect associated with DC plans is virtually all financial risks of retirement are transferred to the employees, including both investment risk (the risk of investment losses) and longevity risk (the risk of outliving retirement assets) (McHale 2012). DB plan participants are protected against these types of risk because the plan sponsors assume such risks in promising to provide participants with guaranteed retirement funds. With DB plans, these risks are efficiently pooled across a large number of participants; under DC plans, it is the employee’s responsibility to invest in well-diversified portfolios to experience a similar pooling of risks (Marcks and Kalamarides 2011). A crucial question to ask in the discussion of DC risk is this: If plan sponsors—with support from actuaries, attorneys, and investment experts—feel that pension risks are unmanageable, how much more so are they when laid at the responsibility of members with limited knowledge (Shlesinger 2012)?

From a big-picture point of view, an employee’s risk from a DC plan is the risk that there may not be enough money in the plan to pay adequate benefits (Rappaport, Schaus, and Clymer 2011). As of July 2012, employees end up outliving their savings 55% of the time, despite following disciplined retirement savings regimens and financial guidelines throughout their lifetime (McHale 2012). Not only does risk from DC plans directly affect plan participants upon the switch from DB plans, but it actually increases as participants near retirement; as employees age, they lose the human capital they once

had—a sufficient number of years left in which they could work to make up for investment losses (Rappaport, Schaus, and Clymer 2011).

It is also worth noting that outside of financial and longevity risks, employees also deal with many other risks as they near retirement, including the costs and issues that arise with health care, long-term care, family situations (death of spouse), independent living, real estate, and maintained employment (McHale 2012). Not only are employees under defined contribution plans forced to deal with these risks inherent in retirement, they also have to recognize and manage the risks that come with having full control of their investments.

An additional negative aspect of defined contribution plans is the uncertainty they cause for employees regarding when one can retire. Because of the exposure to market fluctuations, retirement decisions become sensitive to business cycles and participants are subject to less predictable retirements. For example, the recent economic recession has caused 35% of employees over the age of 62 to delay retirement. Because of these exposures, DC plan participants tend to predict their retirement dates less accurately than DB plan participants, who know their exact retirement income (Marcks and Kalamarides 2011). The combination of longevity, investment, and business cycle risks that continue throughout retirement leads to an unguaranteed amount of income for DC plan retirees. In contrast, DB plans guarantee a specific amount of retirement income for the participant's remaining life.

Due to the negative aspects just discussed, the switch to defined contribution pension plans results in many long-term effects on employees and their families; these effects include (but are not limited to) delayed retirements, higher savings requirements,

lower standards of living, and increased poverty rates among participants. Plan participants may, in essence, hedge the risk of outliving their retirement assets by delaying their retirement in order to accumulate additional funds against potential longevity and poor market performance. An analysis performed by *Benefits Magazine* in July of 2012 indicated that an additional five years of work past the age of sixty could lessen the chances of outliving assets from 55% to 25% (McHale 2012). Additional research by *Pension Benefits* revealed that, on average, DC plan participants tend to retire one to two years later than employees covered by DB plans. This research also indicated that in any given year, DB participants are 87% more likely to retire than individuals covered only by a DC plan (Marcks and Kalamarides 2011). It is important to note that the intention to delay retirement may not always be fulfilled due to job loss, poor health, or family members needing care.

DC plans require an increased level of savings relative to DB plans for a similar level of retirement income— a direct result of the lack of investment risk pooling within a DC plan (Marcks and Kalamarides 2011). Employees under defined contribution plans typically are not paid more than those with DB plans, but must save more; those under DB plans almost always have a greater total compensation than those with DC plans. In order for a defined contribution plan participant to reduce their chances of outliving their retirement savings to a still risky 30%, he or she would have to apply a thirty-year savings rate of 15% (McHale 2012). To reduce that risk further, the participant would have to apply a higher savings rate, which may not be plausible for some families. To make matters worse, if the market performs poorly, participants may be forced to later reduce their retirement income, no matter the savings rate they chose to apply

beforehand. These increased savings requirements threaten the mindset of many people- that they must spend all that they make. As retirement security becomes less certain, our spending habits must change. Plan participants must realize that they are not only working to provide a certain lifestyle for themselves now, but for their future as well.

Lastly, recent research by The National Institute on Retirement Security revealed that DB pension income plays a vital role in reducing the risk of poverty and material hardships among older households. Given the current trend of switching from DC pension plans to DB pension plans, older American households may face greater economic hardships and greater dependence on public assistance to meet their basic needs than ever before. According to the authors, Dr. Frank Porell and Diane Oakley, employees with DB pension plans can accumulate greater retirement wealth than those with DC pension plans because they do not face complex decisions such as whether to participate, how much to save, and how to invest and draw down their savings (Porell and Oakley 2012).

DB plans are an essential source of income for households seeking to maintain a middle-class standard of living during retirement; however, DC typically plans are not reliable enough alone to guarantee a specific standard of living during retirement. In 2010, rates of poverty among older households without DB pension income were approximately nine times greater than the rates among similar households with DB pension income (Porell and Oakley 2012). The authors also analyzed the rate of material hardships, including food insecurity, shelter and medical hardship, and reliance on public assistance amongst households with DB pension income and those without; in each case, hardships were significantly lower among households with guaranteed DB income. For

example, food insecurity hardships were approximately 2.3 times greater among older households without DB income than their counterparts with DB pension income in 2010 (Porell and Oakley 2012). It is important to note that the switch from DB plans to DC plans does not necessarily cause poverty or material hardships for employees and their families, but increases the risk and probability of such occurrences. The switch can, however, limit a family's ability to maintain a middle-class standard of living (or the standard experienced before retirement) during retirement.

In support of the proposition that employers will overemphasize the positive aspects and understate the negative aspects discussed above, theories of social influence and economics-based utility maximization can be applied effectively. The social influence theory of behavioral psychology by Herbert Kelman identifies three broad varieties of social influence: compliance, identification, and internalization. Kelman, an early social psychologist, investigated how people influenced one another, particularly within situations of stress or conflict. His research on identification supports the first proposition.

Identification is the changing of attitudes or behaviors due to the influence of someone that is liked or offers potential reward; it can occur when a person accepts the teachings of another individual in lieu of learning through practice (Kelman 1958). In the midst of a switch from DB plans to DC plans, employers may overemphasize certain advantages to employees with the goal of identification. The employee (the identifier) will then identify with the potential rewards that the employer offers (and overemphasizes) through DC plans and will underestimate many of the negative long-term effects of the plan. In lieu of researching DC plans, employees may instead simply

accept the guidance of their employer and feel confident in their existing knowledge. It is natural for employees to identify with the employer as this theory suggests because employees depend on their employer for a living; a dependent relationship such as this can cause employees to trust the company they work for. This theory assumes that such a sense of trust exists between the employer and employee.

Simple economics-based theories, including rational choice and utility maximization, apply to the first proposition in regards to the employer's behavior. Rational choice theory defines rationality to mean that individuals will act as if balancing costs against benefits to arrive at action that maximizes personal advantage (Scott 2000). The employer, representing the firm, makes the switch from DB plans to DC plans to balance cost against benefits; DC pension plans cost less for the firm to manage; therefore, it is a rational decision to arrive at maximum advantage for the firm (not the employees). The firm is working on its own behalf to arrive at its ultimate goal: profit. In order to avoid employee outrage, employers will overemphasize and understate aspects as they see necessary.

Similarly, utility maximization theory states that individuals will behave accordingly to meet the objective of maximizing total value from the expenditure of least amount of money (Aleskerov, Bouyssou, and Monjardet 2007). In application to the first proposition, the behavior of the employer is directly related to maximizing the firm's value in terms of decreased costs and decreased responsibility in DC pension plans. In combination, these theories of influence and rationality support the behavior of employers proposed above.

Proposition Two

The second proposition states that the switch from defined benefit to defined contribution pension plans will disrupt effective workforce succession, affecting younger generations of employees as well as retirees. In this section, I first define workforce succession and convey the importance of workforce succession planning during the switch from DB to DC pension plans, then provide evidence about how workforce succession might change as a result of the pension switch, and discuss how this change will affect both employers and employees.

Webster's dictionary defines succession as "the act or process of one person's taking the place of another in the enjoyment of or liability for rights or duties" as well as "the continuance of corporate personality." When referring to succession in the workforce, the term deals with filling job positions as they become open to continue successful operation of the firm. According to Henry Fayol, management theorist, workforce succession must be planned and managed by a firm to effectively "ensure the stability of tenure of personnel"; if succession is ignored or left unplanned, key positions may end up being filled by ill-prepared people (Fayol, 1914).

Workforce succession planning and management is typically best understood as "any effort designed to ensure the continued effective performance of an organization, division, department, or work group by making provision for the development, replacement, and strategic application of key people over time." Effective succession planning includes an organization's deliberate effort to ensure leadership continuity in key positions, to retain and expand intellectual and knowledge capital for the future, and to encourage individual advancement (Rothwell 2010). According to *Benefits Quarterly*,

if not handled correctly, succession can expose a company to significant risk. The issue of succession planning management is one that can impact the company's cash flow, culture, ability to compete for top talent, and productivity (Arnone 2006). Strategic success of a firm is dependent on having the right leadership; therefore, effort must be made to ensure that the firm is identifying and preparing candidates for critical positions.

The connection between pension plans, workforce succession, and workforce succession planning exists as a result of potential delayed retirements and unplanned departures by DC pension plan participants. Some employees may see the pension switch as a reduction of their overall compensation value and seek employment elsewhere with higher compensation; however, salary surveys indicate that this is not common because employees are not likely to find higher compensation elsewhere. As discussed earlier, the switch from DB to DC pension plans may also result in delayed retirements as employees attempt to hedge investment and longevity risks and less predictable retirements overall. While employee longevity with the firm can deliver many advantages to the employing company, it can also disrupt effective workforce succession if employees continue to work only because they cannot afford to retire (McHale 2012). The resulting delayed retirements have the potential to negatively affect employers by making it harder to anticipate and manage staffing needs, increasing workforce costs, and decreasing employee engagement.

To make matters worse, each of these workforce challenges is likely to become more prominent over the next several years as the number of employees over the age of 55 is expected to grow by more than 40% by 2018 (Marcks and Kalamarides 2011). Note that the following arguments are premised on the assumption that the market will

continue to perform at its recent rates or worse. In the event of the stock market performing increasingly better, firms sponsoring defined contribution pension plans may actually need to worry about the opposite problem—employees choosing to retire early as a result of strong investment performance.

First, the switch from DB to DC pension plans can cause increased volatility in staffing needs within the organization. Employers face this volatility because defined contribution participants' retirement decisions are profoundly impacted by fluctuations in the financial market (Marcks and Kalamarides 2011). Research by Prudential Retirement indicated that DC participants are more likely to delay retirement when financial markets decline, which is likely to occur when employers are already facing economic headwinds in their business. Economic headwinds refer to events or conditions that slow the growth of an economy; examples include credit crisis, rising costs, and natural disaster (Stack Exchange). During these periods of decline, employers would prefer that forecasted employee retirements take place instead of premature or continuously delayed ones (Marcks and Kalamarides 2011).

Second, the pension switch and delayed retirements have the potential to increase employer workforce costs. For example, delayed retirements will increase the cost of having to wait (longer than expected) to replace higher-compensated employees with lower-compensated, younger workers. Prudential Retirement's research indicated that in 2011, surveyed employers expected that only half of their employees would have the resources needed to retire at the firm's traditional retirement age (Marcks and Kalamarides 2011). If employees who lack such resources decide to delay retirement past the traditional age (specific to the firm), the organization's costs will increase above

budgeted projections made according to traditional retirements. In addition, delayed retirements may also increase an employer's annual healthcare cost. According to Prudential, the annual healthcare costs for a 65 year-old worker are twice of those of a worker between the ages of 45 and 54 (Marcks and Kalamarides 2011). Consequently, increases in healthcare costs as a result of delayed retirements can be significant for employers.

Third, the switch from defined benefit to defined contribution pension plans and delayed retirements may also reduce an employer's ability to hire new employees (Marcks and Kalamarides 2011). A firm may not have the resources to bring in additional employees when many that were expected to retire at the traditional age are now continuing to work. In 2006, *Benefits Quarterly* estimated that the number of U.S workers between the ages of 45-54 and 55-64 would increase by 21% and over 50%, respectively, by 2010 (Rappaport 2011). Without the ability to hire new employees, the flow of new ideas and talent into a firm will decrease significantly. Firms with DC retirement programs will likely see an older workforce over time and may be challenged in their need to bring in younger employees with new views and skill sets (Wagner, 2012). Without a continuous flow of fresh ideas and young, vibrant talent into a firm, the firm may become stagnant in its ways and lack the human capital necessary for innovation. It is important to note that there are also benefits to delayed retirements if the employee who can't retire is providing significant institutional knowledge and skill that cannot be readily replaced by a new, younger worker.

Lastly, delayed retirements can lead to reduced workforce engagement (Marcks and Kalamarides 2011). The Hay Group defines engaged performance as "a result that is

achieved by stimulating employees' enthusiasm for their work and directing it toward organizational success" (Morlis and Schubert, 2001). As defined contribution plan participants work longer, the succession occurring in the workplace is significantly slower. Typical succession plans may be thrown off and employee expectations in terms of promotion opportunities may not be met. Employers may experience decreased employee engagement as a result, which can affect overall firm performance.

Younger employees will likely become discouraged by the resulting lack of advancement opportunities, which are typically strong motivators for employees hoping to advance through the corporation; therefore, this shortage of growth opportunities may result in decreased motivation and weaker performance by younger employees. Older employees who are closer to retirement may also be affected; they may not be motivated to work more productively when they know that within 10-15 years they will retire with the same paycheck. *Employee Benefits* magazine claimed that among those who are de-motivated, the most popular reason is having an uncertain future (Coles, 2001), which may be a result of a work environment with little succession. There are many existing theories to support this decrease in employee motivation, including Frederick Herzberg's motivation-hygiene theory (also known as two-factor motivation theory) and The Engaged Performance Model created by the Hays Group in 2001.

According to Frederick Herzberg, there are two types of factors in motivation. First, there are motivating factors, which, if present, will enhance performance and increase motivation. Second, there are hygiene factors, which if absent, will decrease motivation and negatively affect performance (Herzberg, 1959). Hygiene factors relate to an employee's work environment, which provides basic needs, acceptable security, and a

sense of belonging and fellowship. For the purpose of relating to proposition two, it is the motivating factors that support the decreased motivation in DC employees discussed previously. Motivating factors include a sense of achievement, personal growth and advancement, job interest, recognition, and challenges and simulations at work. These are the true motivators (Gurus on People Management, 2005). Defined contribution plan participants may lack many of these motivating factors including personal growth, advancement, and challenges at work, as a result of delayed retirements. Herzberg suggests both greater responsibility and job enrichment to increase employee motivation (A to Z of Management Concepts and Models, 2005).

The Hay Group, a global management-consulting firm, has identified six motivational drivers that help create sustained performance by engaging the workforce. The drivers are: quality of work, work/life balance, inspiration values, enabling environment, future growth/opportunity, and tangible rewards. In support of proposition two, future/growth opportunity and tangible rewards relate to the probable decreased motivation among DC participants discussed above. Future/growth opportunities include career advancement opportunities and learning development beyond the current job. Tangible rewards include competitive pay and ownership potential, which typically increase with promotion (Morlis and Schubert, 2001). As defined contribution aging workers continue to work only because they can't afford to retire, these motivational drivers may no longer exist for others in the organization.

It is clear that the switch from defined benefit to defined contribution pension plans affects employers and employees in many ways, some positively and some negatively. Employers may experience increased volatility in staffing needs, higher

workforce costs, and/or reduced workforce engagement. Employees, both young and old, may experience decreased motivation to work productively as a result of the switch. The second proposition reveals how workforce succession planning becomes increasingly important during such times of change to avoid reduced workforce engagement and low employee motivation. The negative effects of the pension plan switch are significant. Ignoring succession planning and employee motivation factors may be detrimental to a firm and its past, current, and future employees.

Proposition Three

Proposition three states that when the actions of companies that have switched, or are currently switching, from defined benefit to defined contribution pension plans are evaluated against prescribed ethical theories and models, their actions and the resulting effects will be deemed unethical. In support of proposition three, company actions are evaluated against two models: the employee moral rights theory and the deontological ethics theory. Two separate evaluations of company actions allow readers to truly comprehend the unethical actions being taken against employees in making the switch of pension types. It is important to note that the behaviors claimed as unethical within this proposition are limited to those done in situations in which the pension switch is detrimental to workers; these situations are relevant to the discussion below.

Before delving into ethical theories to evaluate company actions, it is critical to first touch upon the importance of the employer-employee relationship as a building block for ethical behavior. In achieving the ideals of ethical behavior between employer and employee, the firm must find ways to balance ethics, social responsibility, and the rights of both employers and employees (Berkley & Watson, 2009). Often times,

corporations include an assessment of company stakeholders in evaluation of their own social responsibility. Although employees are typically included among company stakeholders, employers tend to downplay or even forget to consider the significance of employees during the evaluation. Although shareholders get most of management's attention, the employee is one of the most important stakeholders an organization can face; unfortunately, they tend to get ignored when considering the ethicality of decisions (Berkley & Watson, 2009). The switch from defined benefit to defined contribution plans may be evaluated differently if companies strongly considered their own employees in determining the ethics behind the decision.

It is also important to note that the employer-employee relationship is a reciprocal one, which also relies on the responsibility of individual employees to be truthful and candid with their employer. The relationship goes both ways- each party owes the other consideration of ethics in decision-making. The relationship is not a static one- it is shaped by market trends, environmental conditions, and emerging technologies (Berkley & Watson, 2009); however, the consideration of such factors does not excuse unethical behavior by either party. Viewing the employee-employer relationship as a building block for ethical behavior is an important attribute to a successful and accountable organization; thus, considering this relationship while evaluating the ethics behind the pension switch is important. According to an ethics article that appeared in *Strategic Finance*, success is ultimately about keeping your word, and "companies that live up to their promises are successful" (Hunter, 2008). By evaluating the actions of companies making the pension switch, it will be clear whether or not those companies were successful in living up to their promises.

Company actions are first evaluated against the theory of employee moral rights, which strives to recognize the implicit financial investment made by employees in an ongoing employment relationship. According to this theory, employees have specific moral rights by virtue of their contribution to the organization they work for just as citizens of a given country have specific moral rights by virtue of their participation in it (Radin & Werhane 2003). Unlike legal rights, moral rights are justified through ethical reasoning and are valid in spite of the lack legal support (Rowan, 2000).

Moral rights concern the protection of vital individual interests and are particularly relevant when employer and employee interests conflict (Montemayor, 2008), as they do in the case of the pension switch (a stronger bottom line versus adequate retirement funds). Two categories of moral rights exist: workplace human rights and employee moral rights. Workplace human rights focus on treating employees as persons and an employee's right to privacy. Employee moral rights, which will be focused on in support of proposition three, may be defined as "the moral claims individuals are entitled to due to their role as employees within an ongoing employment relationship (Montemayor, 2008).

It is critical to note that prevailing management theory and practice are based on a spot market transactional view of employment relationships, and many theorists and business executives would disagree that employees have implicit financial investments in their employing organization. However, such spot market transactional views make qualitative and impractical distinctions concerning a firm's relationship with its shareholders versus a firm's relationship with its employees (Montemayor, 2008). Under this view, shareholders are viewed as investors while employees are viewed as spot

market traders receiving compensation in exchange for their work. In reality, dedicated shareholders, who place a large fraction of their equity within a firm or own a significant portion of the firm's capital, are true financial investors. Similarly, committed employees who have had a considerably long employment relationship with the firm are also financial investors (implicitly). According to neo-classical economics, price in competitive spot markets equals the value of what is traded; therefore, dedicated employees make significant financial investments to the extent that they accept compensation that is less than the economic value of their contributions (Montemayor, 2008).

The spot market view of employment relationships is ethically lacking because it leads to the destruction of financial investments made by dedicated employees of the firm. An ethically oriented view would acknowledge the implicit, yet significant, financial investment made by employees. After all, the moral foundation for employee rights focuses on treating employees as persons, making them morally significant and recognizing them appropriately (Rowan, 2000). Accordingly, the employee moral rights theory is a great example of an ethically oriented view. According to this theory, employees are recognized as financial investors and they ought to have five major rights: (1) the right to be treated the same as every other investor, (2) the right to share in the firm's financial success, (3) the right to timely, accurate, and sufficient disclosure of all significant matters, (4) the right to protection from senior managers' abusive self-dealing, and (5) the right to mechanisms intended to protect their financial investment (Montemayor, 2008).

Each of the five major rights listed above is related to the employee rights at stake upon companies switching from defined benefit pensions to defined contribution pensions. If devoted employees truly were recognized as implicit financial investors, each right would have radical implications on a firm and its human resource management (Montemayor, 2008). In support of proposition three, the evaluation of company actions focuses only on the employee's right to be treated as every other investor (1) and the right to mechanisms intended to protect their financial investment (5).

If the first right were applied in accordance with treating employees as financial investors are treated, employees would be provided or would participate with a set of representatives in charge of overseeing management's actions and decisions (similar to what a firm's board of directors provides for shareholders). Researchers have even argued that these employee rights should actually take precedence over investor rights because committed employees incur more financial risk than the majority of shareholders (Montemayor, 2008). Employees are certainly less well diversified than financial investors because they have both their human capital and their source of income invested with the employer company. Evidence behind this argument includes the fact that shareholders can easily remove their capital, a tangible resource, from a firm and take it elsewhere and have the ability to diversify their investment portfolios as they choose. Conversely, employees contribute multiple intangible resources including their time, human capital, and personal sense of worth-- all of which are highly correlated to an employee's future in the workplace. These intangible resources are comparatively difficult for employees to withdraw from the firm they work for or transfer elsewhere

and it is nearly impossible to diversify such resources across multiple employers (Montemayor, 2008).

In evaluating the actions of companies making the pension switch, it is clear that firms do not recognize or treat their dedicated employees as implicit financial investors. Today, the thought of employees taking precedence over investors may seem foreign and absurd to most firms; but as discussed above, without solid reason. Most firms do not actually have a board of employee representatives in place, but such boards do exist in other countries. In Germany, the Board of Directors (also called the Supervisory Board) is typically composed of twenty members, ten of whom are elected by the shareholders and the other ten are employee representatives (Windbichler, 2006). Germany and some other European countries run their businesses based on the principle of co-determination, a practice in which employees have a role in the management of a company. Other than this representation factor, financial investors are also treated with the upmost respect by management and unethical actions are typically avoided at all costs. According to the employee moral rights theory, employees should be given the same respect as shareholders and ethical implications should always be considered when making decisions that may affect them.

In the case of the pension switch, it seems as if employees tend to be ignored when considering the scope of ethical decisions (Berkley & Watson, 2009). It is difficult to imagine that a firm would cause the same difficulties for explicit financial investors as some have caused for employees in switching from DB to DC pension plans; such difficulties include: increased risk, higher savings requirements, unguaranteed retirement income, delayed retirements, and possibly a lower standard of living.

According to this theory, the second right, employees have the right to share in the firm’s success, implies that profit-sharing should be mandated (as it has been in Mexico and France). In combination with the first right, these rights imply that employees have a right to profit-sharing that is comparable to the dividends that a shareholder may receive. The third right, the right to timely, accurate, and sufficient disclosure of significant information, supports the practice known as “open book management,” in which employees have access to adequate information regarding the following: financial and operating results, strategic plans, and compensation plans for executives and employees. The fourth right states that employees have the right to protection from senior managers’ abusive self dealing; if applied, it would require firms to release information regarding significant conflicts of interest that occur between senior management in connection with strategic policies and decisions that may affect employees (Montemayor, 2008).

The fifth right of the employee moral rights theory states that dedicated employees should have the right to mechanisms intended to protect their financial investment, implying that they have the right to effective pension protection that ensures they receive the entirety of their vested pension income (Montemayor, 2008). This right also implies that employees should receive a fair severance package when terminated without just cause; however, the first implication will be focused on in support of proposition three.

When firms choose to switch from DB to DC pension plans, employees lose the guaranteed income effect of defined benefit pension plans. DB plan sponsors promise to provide participants with a guaranteed retirement paycheck (Marcks & Kalamarides,

2011); however, DC plan participants endure the risks of investment losses and outliving their retirement assets, as discussed in proposition one. In terms of receiving the "entirety of their vested pension income" as stated in the fifth right, defined contribution plan participants can never be sure of the amount that they will actually receive during retirement because of market fluctuations.

Additionally, under DB pension plans, plan sponsors act as a mechanism intended to protect participants' financial investments, managing the retirement investments and making changes as necessary. Under DC pension plans, employees no longer have this protection mechanism, but instead must rely on their own knowledge and abilities to manage their own retirement investments. Clearly, when evaluating the actions of firms in making the switch from DB to DC pension plans, they do not measure up to the fifth right of the employee moral rights theory. In making the pension switch, some firms have not provided the employee rights outlined above. Although only the first and fifth rights were analyzed, the other three rights within the theory can also be analyzed to provide the same outcome. Therefore, one can deem their actions unethical according to the employee moral rights theory.

To provide additional evidence for the third proposition, I evaluate employer actions against the deontological theory of ethics, which focuses on duties, obligations, and principles. According to an article in the *Journal of Business Ethics*, "an ethical reinvigoration of the business world can only be accomplished by encouraging the business realm to impose upon itself some measure of self-regulating along the lines of deontological ethics (Micewski & Troy, 2007)." Deontologists make their decisions about what is right based on wide spread, conceptual, universal principles or values such

as honesty, promise keeping, fairness, and loyalty (Trevino & Nelson 2004). Philosopher Emmanuel Kant designated a particular form of deontological thinking through his "categorical imperative" theory: act as if the maxim of one's action were to become a universal law of nature." In applying this imperative, one must ask himself/herself, "Is the rationale for my action appropriate to become a universal law or principle for everyone to follow?" (Trevino & Nelson 2004).

Some may argue that the deontological theory of ethics is weak because it fails to focus primarily on the consequences of an act, and focuses too much of the rightness or wrongness of an act itself. However, ethics devoid of such deontological aspects has been claimed to be "in the end, no true ethics at all" (Micewski & Troy, 2007). When business is operated with a main interest on the consequences regarding leaders' wealth and reputation, there is no concern of their duty to employees, investors, and other parties.

Under the theory of deontology, the ends of an action can never justify the usage of any or all means, for one must act out of respect for the moral law (Micewski & Troy, 2007)." This includes treating employees with respect, not treating them as things, objects, or tools in an effort to achieve a manager's or a corporation's goal (Rowan, 2000). Unfortunately, many individuals and corporations have adopted the philosophy that "the ends justifies the means," defining success by external sources and ignoring the ethicality of their actions. An exclusive focus on an action's desired outcome potentially degrades employees to a mere means for one's goal (Micewksi & Troy, 2007), failing to treat them as real persons.

In the case of firms switching from DB to DC pension plans, it seems that the decision to make the switch may have been made with primary focus on meeting the

corporation's goal—maximizing profit and minimizing costs. In evaluating these actions, it appears as though the effects of the switch on employees were considered means to an end. Under deontology, universal principles of promise keeping, fairness, rights, and respect should have been applied; however, these values are not upheld in switching employees from DB to DC pension plans. Employers break their "promises" of guaranteed pension income and the switch clearly leads to unfair effects on employees (as discussed in the first and second propositions).

In asking the question of whether or not the employers' rationale for their actions was suitable to become universal law for everyone to follow, it is clear that their actions cannot be justified according to the deontological theory. If all corporations made decisions considering the desired outcome far more than considering the effect on employees, firms would struggle to keep anyone employed. In an ethically just corporation, according to the deontological theory, moral duties would transcend profit maximization (Micewksi & Troy, 2007). Had corporations acted ethically, according to this theory, in making the decision regarding making the pension switch, managers would have considered the unethical effects on employees more than profit maximization. It is easy to see how the decision to make the switch may turn out differently if this type of thinking is applied.

The real test of ethical behavior is whether people are willing to do the right thing- the thing that could serve as a maxim for everyone's actions—even when it is not exclusively done in self-interest (Micewksi & Troy, 2007). After taking into account the evidence provided for all three propositions discussed above, corporations that made (or are currently making) the switch from defined benefit to defined contribution pension

plans would not pass this test. Analysis of two separate ethical theories, the employee moral rights theory and deontological theory, leads to the conclusion that the actions of companies regarding the pension switch can be deemed unethical.

In the face of difficult times and unpredictable futures, companies must never compromise their ability to make ethical decisions for any reason (Hunter, 2008) as they did when making pension decisions. Starting now and into the future, companies must learn from these experiences, establish an ethical environment, and learn to view and treat employees as one of the most significant stakeholders of their firm in order to prepare for a better way forward; otherwise, company leadership will have to accept the very real consequences of failing to take action today.

DISCUSSION

As with any research project, limitations are inherent in the completion of a thesis. In undertaking the completion of this thesis, three main limitations existed: the use of non-quantitative analysis, the subjectivity of defining *ethical* versus *unethical*, and an overall uncommon opinion on the treatment of employees as implicit financial investors. In order to overcome these limitations, it was vital that I thoroughly researched the topic at hand and gained knowledge from multiple sources to completely understand and defend my final argument. Although these limitations are not separately identified throughout the propositions above, I have attempted to include substantial and valid support within the literature review to overcome the limitations.

The use of non-quantitative support (theory-based support) is a limitation because it can be perceived as overall weaker evidence versus quantitative analysis when used to support propositions. In completing my research, I did not complete surveys, archival

data collection, or experiments. Instead, the three propositions within are purely theory-based and supported by the review of literature; thus the reason it was so important that I studied many academic articles and trustworthy sources (almost thirty) to complete the literature review. I believe the amount of research I completed is adequate to support the propositions within without additional qualitative or quantitative analysis. The development of three separate propositions to answer the main question also increases the validity of the literature review.

The subjectivity of defining *ethical* versus *unethical* is a limitation because the third proposition is entirely based on ethics- what is considered ethical and what is considered unethical. Because every person is entitled to have their own opinion on the ethicality of certain actions, it was difficult to "correctly" judge the ethicality of actions of corporations relating to pensions and retirement. In order to overcome this limitation, I used two different, pre-existing, and well-known ethical theories (Employee Moral Rights theory and Deontological theory) to measure the ethicality of certain actions. Although the reader may still disagree with the opinion developed within the third proposition, it is supported by existing research, rather than just a personal opinion.

Lastly, a major limitation in completing this thesis is developing an overall argument that goes against most commonly held business beliefs. The gist of my argument within claims that 1) employers making the switch from defined benefit to defined contribution pension plans are hurting employees more than helping them (in the current economic situation) and 2) the effects on employees are not considered significantly enough by company leadership when making retirement-releated decisions. Obviously, the leaders of corporations have valid reasons for making their decisions

regarding pensions and employee retirement plans because most large corporations are making similar decisions, so it is difficult to argue against them: however, this limitation did not keep me from attempting to do so within the third proposition. Again, heavy research and the use of many sources as well as discussion with others helped me to provide adequate support for my opinion within.

The completion of this thesis allowed me to develop ideas for future studies and suggest next steps in this area of research. The main idea gained from my research is this: in moving forward to an improved state for both employees and employers, a greater availability of tools (some of which have not been developed) must help bridge the gap between employee resources and their ability to reliably manage the risks of financing retirement. Currently, the switch from defined benefit to defined contribution pension plans is shifting much of the responsibility of managing retirement risks from employers to employees; however, employees are not always being adequately equipped with tools and resources to do so.

Not only do simple tools need to be created and provided to employees, but employers also need to educate their employees about the effects of the pension switch- both positive and negative ones. When employees are handed full responsibility of managing their retirement savings without proper education and resources, employers are neglecting to help bridge the existing gap. The creation of new tools and resources will require greater efforts on the part of plan sponsors, individuals (employees and employers), service providers, and policy makers. Future studies can help to identify specific tools and resources that will help most in managing the financial risks inherent in saving for retirement.

I also suggest that future studies be done to research specifically how young employees and students can prepare for the current changes in retirement plans. As a student about to enter the working world, I would benefit immensely (as would most other college students and young employees) from research targeted specifically towards my generation in regards to retirement planning. My generation (Generation Y) has been taught the importance of saving for retirement, but has not been taught how exactly to do so or even how current retirement plans work (and most employers neglect to educate us). Obviously, the parameters of retirement have changed since the beginning of defined benefit plans and we need to be equipped to deal with these changes. When retirement plans began, employers expected to pay the employee for only 5 years (on average) after retirement. Today, people are living much longer after retirement- on average 20-25 years. It takes two- both employer and employee- to plan for such a long retirement.

I would have never known about the current changes occurring to most retirement plans had I not chosen to write about my specific thesis topic. The knowledge gained from my research will help me plan for my own retirement, so I think it is important that other students and young employees are educated as well. These changes can and will have significant effects on how my generation should be planning and saving for retirement. A study specifically geared towards educating my generation about retirement planning by defining the effects of current changes on Generation Y in particular would be extremely valuable to the young employees of corporations. These studies would also educate corporations on how they, as the employers, can best serve their youngest employees.

IMPLICATIONS

The findings of this thesis will not only be relevant for academics, they will be relevant for non-academics as well, including employees, employers, and students (prospective employees). The findings within will equip employees and future employees alike with knowledge of what can be considered ethical and unethical in regards to the treatment of employees, what to expect in regards to a pension plan, and how the plans have recently changed.

Retirement is inevitably going to affect most people, so any research surrounding planning and saving for retirement is going to be beneficial for many. The findings within highlight the fact that retirement benefits will not simply be handed to employees as they once were and that saving and managing retirement money will likely be the employee's full responsibility. The findings stress the importance of saving and planning for retirement at a young age—an extremely valuable lesson for both students and young employees alike.

The findings will also be relevant to employers because they could actually change the way employers view and/or treat their employees. Proposition one defines both the positive and negative aspects of DC pension plans and outlines the long-term effects of the pension switch on employees, which employers may not realize even exist or may not understand the level of their severity. Proposition two will have great relevance for employers because it describes how the pension switch will disrupt effective workforce succession. The effects on the employer can potentially threaten the success of a company overall. Proposition three will also be very relevant for employers

because it measures company actions against ethical theories and defined their ethicality. The outcome of these theories may surprise employers.

After reading the findings within the literature review, employers can begin to develop ways to help employees better plan for their retirement. For example, employers could develop and offer an ideal retirement planning model, which should do the following: be engaging and informative, present complex results simply without being misleading, encourage employees to return, review, and revise their plans often, and mitigate employer and employee risk (Shlesinger, 2012). According to an article in *Pension Benefits* magazine, any solution to enhance defined contribution plans should be evaluated from the following perspectives: improvement of plan performance, impact on workforce management, and alignment with individual preferences (Marcks and Kalamarides, 2011). As employers take the findings of the research within this paper into account and take action based on their new knowledge, employees will benefit from the results.

Based on my findings, my advice for companies dealing with issues surrounding pensions and/or retirement plans in general is to seriously consider how a decision may affect employees and the ethical consequences of that decision before finalizing any changes to retirement plans and/or corporate policy. My research has revealed the lack of consideration given to employees, the ones directly affected by changes to retirement plans, when decisions are made. My analysis of two separate ethical models within indicated that the way companies are making decisions, taking consideration primarily of shareholders and the bottom line, can indeed be deemed unethical (when the decision results in negative effects on the employee). I do not believe that these corporations are

intentionally hurting their employees or treating them unethically; however, I also do not believe that corporations are intentionally taking serious consideration of their employees and the consequences of retirement-related decisions. Therefore, I would suggest to company leadership that they take time to research the theory of Employee Moral Rights, which claims that employees must be respected and never treated as means only (Rowan, 2000). With this frame of mind, a morally defensible formulation of corporate policy, and interpretation of such policy in particular situations, can be more easily achieved.

Ultimately, ethics is the framework for success; however, the enormous pressure on corporations to produce higher and better returns has led some to adopt the philosophy that the "ends justify the means" (Hunter, 2008). Firms continue to allow external sources to define success, while their internal sources suffer as a result—the pension switch and its effects are a good example. According to an article in *Strategic Finance*, top management needs to use five key elements to establish an ethical environment and build trust: integrity, competence, consistency, loyalty, and openness with employees, vendors, and stakeholders. My hope is that corporate leaders take these ethical factors into consideration, in combination with my research findings, and adjust corporate policy or decision-making tactics as necessary. Each day, management decisions affect the future of not only individual employees, but their families as well. Before making a final decision, the goal should be to completely consider the ethical implications, including the lasting consequences, on one of the firm's most important assets- its own employees.

CONCLUSION

In the current economy, employees are increasingly being forced to bear all the financial risks of retirement; however, their ability to retire comfortably is questionable

with only a DC portfolio plan. As discussed throughout the paper, the effects of the pension switch can be severe for both employee and employer. While DB plan participants are protected against investment and longevity risk, DC participants accept all of the risk that exists with planning for retirement. DB plans pool the risk across many participants; because this does not occur under DC plans, they require a higher level of saving on a per-employee basis. As detailed in proposition one and two, the major potential effects of the pension switch include delayed and less predictable retirements, increased volatility in staffing needs, higher workforce costs, and reduced workforce engagement.

As proposed in proposition three, these effects are proved to be unethical against certain theories. The intent of the third proposition was not to convince employers of their unethical acts, but to make them aware of the situation at hand. As seen through various ethical models, employees should be seen as a more significant aspect of a company, arguably even at the same level as financial investors. If companies begin to look at their own employees as such, they may treat their employees differently and consider them more heavily when making decisions regarding retirement and pension plans. I hope to one day see large corporations considering their employees as their most important asset and taking actions to treat them accordingly.

This paper presented information about the pension switch overall and the effects of the employer's decision to do so. The opinions developed within are obviously personal ones, but I hope the analysis and literature review within have provided the reader with adequate information to form their own opinions on the topic as well as think about the responsibility of planning for retirement. There are not many trends as

foreseeable and irreversible as the aging of the working population; therefore, it is necessary for both individuals and corporations to adequately plan for the trend itself as well as the impact of this trend on the nation's workforce, corporations, and economy. Time management author Alan Lakein once said, "Planning is bringing the future into the present, so you can do something about it now" (Shlesinger, 2012). Now is the time for employees and employers to do something about the future of retirements, to reconsider the current retirement system, and to add an ethical perspective to their decisions.

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ABSTRACT

This study focused on the effects of the trending switch from defined benefit to defined contribution pension plans. Specifically, I examined how the pension switch affects employers and employees and how the actions of employers making the pension switch measure up against pre-existing ethical theories. Based on my research of current academic articles and existing theories, I developed three propositions relating to pension switch. In the paper, I describe positive and negative aspects of both types of pensions and explain how the switch from DC to DB negatively affects both employers and employees. In addition, I describe how workforce succession can be disrupted as a result of the pension switch and how it may decrease employee motivation, using motivational theories as support. All three propositions are supported with academic research and pre-existing theories. Implications for companies with pension plans are discussed.