

Strange Bedfellows Undermining Private Pensions

By Larry Sher, Principal, Director of Retirement Policy

It might not surprise many Americans to learn that there are two powerful camps that have vastly different ideas about how to deal with what is left of the voluntary employer-sponsored “defined benefit” pension system. But it might surprise some to learn that although the philosophies underlying these approaches differ greatly, the result of implementing either one will be the same: to undermine the current pension system. What, then, are these two philosophies, what do their proponents hope to accomplish, and is there a third — and better — way?

Those in the “ownership society” camp call for a retirement system composed of personal accounts funded and invested by individuals, and encouraged through tax breaks. The transformation of Social Security to personal accounts would be the first step in moving the current system toward its ultimate goal of greatly reducing government entitlements. The Bush Administration seems to be in this camp.

Those in the “entitlement” camp seek a mandatory pension system implemented either through an expansion of Social Security (continuing in a defined benefit form) or through new minimum employer pensions. Proponents see in recent pension plan troubles an opportunity to make the case for greatly expanding retiree entitlements. At the least, they believe that pursuing this course will help preserve Social Security in its current form and benefit levels. The AARP appears to be in this camp.

Neither camp admits to trying to undermine the private pension system. On the contrary, both camps are publicly supportive of the system. But their actions tell another story.

Let’s look at the Bush Administration. First is its proposal to introduce personal accounts into Social Security, the largest defined benefit pension plan in the world. Personal accounts have potential upside for workers but at considerable risk — that inadequate investment returns will lead to inadequate retirement income.

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Second are its pension reform proposals, which focus on bolstering the financial position of the federal pension insurance agency — the Pension Benefit Guaranty Corporation (PBGC) — rather than on encouraging healthy employers to remain in defined benefit pension plans. Increasing the premiums employers pay to the PBGC and imposing new plan funding requirements that will cause employer contributions to become more volatile and less predictable will only drive more employers to curtail or terminate their pension plans.

Third is the Department of Energy's April 27 announcement that by March 1, 2007 it will cease to reimburse contractors for the cost of defined benefits provided to new employees and it will restrict such reimbursements with respect to existing employees. In contrast, defined contribution plan costs remain eligible for full reimbursement. This is perhaps the most blatant evidence yet of the Bush Administration's bias against defined benefit plans. Department of Energy and other federal employees beware — your own defined benefit plan may soon be on the chopping block, too.

There's a certain irony in the DoE's assertion that the new policy is designed to ensure that future costs "are more consistent with market trends" and to "improve the predictability of contractor benefit costs." Many employers have been trying to do exactly what the DoE says it wants to do — better control costs — but are being discouraged from doing so.

Which brings us to the fourth Bush Administration action, its proposal mandating the continuation of current pension plan

accruals if employers want to switch their traditional pension benefit formulas to cash balance benefits — a modern form of pension that well over a thousand employers embraced rather than eliminating defined benefits. One such mandate would require employers to retain the prior benefit formula for all current employees for at least five years following one of these "conversions."

Coming from a conservative Republican administration, that last proposal is truly surprising. Forcing employers to guarantee future benefit accruals is very anti-business, and has never been done before in the voluntary pension system. Apparently, the Bush Administration is willing to go along with the entitlement approach in the short-run to further its long-term goals. But the Administration knows that a voluntary system cannot survive stringent mandates.

Now, let's look at the AARP's actions. The AARP's position on cash balance plans is revealing. The AARP has been providing assistance to plaintiffs' attorneys in large class-action lawsuits against cash balance plan sponsors. It has also been urging Congress to impose new mandates on plan conversions and to leave unaddressed the legal uncertainties faced by existing cash balance plans. The AARP claims that older workers get shortchanged when employers convert their traditional plans to cash balance plans, yet its own study of the 25 largest plans that converted to cash balance revealed that in 23 of the 25, older workers received special transition benefits that helped to protect their benefit expectations.

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The AARP is taking a similar position in a lawsuit against Erie County, Pennsylvania that claims age discrimination. The case involves the right of an employer to provide lower (or no) medical benefits after Medicare begins, generally at age 65. If the AARP gets its way, it must know that many more employers will drop all retiree medical coverage — which will adversely affect many AARP members, especially pre-age-65 retirees.

Also striking is the AARP's relative silence — as compared to its anti-cash balance rhetoric — in the wake of the decision by many large healthy employers to freeze their pension plans. The AARP has to know that older workers can potentially lose much more when plans are frozen than they do in conversions to cash balance — the AARP's own research confirms this. A freeze means no more pension accruals while a cash balance plan provides ongoing accruals (and they tend to be very favorable for older workers).

Exactly what the AARP really wants to accomplish is not entirely clear. Perhaps it anticipates that in a few years it will be able to point to the decimated private pension and retiree medical systems and say that what we need are new entitlements to save the day.

How bad would it be if either side got its way, though? After all, if you hold that the voluntary defined benefit pension and retiree medical systems are on their way out anyway, what harm is there in hastening their demise?

Ah, but there's the rub: both camps act as if the system is already dead. However, to paraphrase Mark Twain, reports of its death are greatly exaggerated. Yes, the voluntary retirement system appears to be on shaky ground right now, but its demise is not inevitable. Yet, if enacted into law, proposals advocated by the two camps could prove to be a form of self-fulfilling prophecy by hastening the end of the system — without leaving something better in its place. What's more, as a practical matter, neither the ownership society camp nor the entitlement camp seems likely to win the argument, at least in the near future.

So is there a third way — a way to build on the strengths of the current pension system? Yes there is, and it consists of two basic steps.

The first step is simply to stop further tearing down a system that has for the most part been highly successful. A good way to start is to impress on members of Congress — especially the so far "silent majority" of moderates — the consequences of undermining the current system.

For example, the ownership society approach would likely leave low wage earners and even many middle-class Americans without a "floor" of protection and with a greater risk of exhausting their retirement assets before death. That, in turn, could result in large numbers of elderly Americans on public assistance. The entitlement approach would greatly restrict employers' ability to tailor programs to fit their particular workforce and business needs. And it leaves unanswered the question of who bears the cost of the mandates — employers, employees, or taxpayers in general.

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The second step is to discourage political warfare over our retirement income security, and insist on a national savings and retirement income policy that forces advocates to demonstrate how their proposals would affect the retirement system. This policy will provide a basis for measuring both the value and the consequences of legislative proposals. Until such a policy is articulated, lawmakers will continue to be tempted by utopian proposals that ultimately will cause much more harm than good.

Congress needs to reject extremist views and act decisively to encourage and strengthen the voluntary pension system — at least until there is a national policy on savings and retirement that spells out the roles of government, employers, and individuals. A wise person does not tear down his or her old house until a new house is built.

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