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Pension Policy: the Search for Better Solutions

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Pension Policy

The Search for Better Solutions

The primary goals of the U.S. pension system are to provide secure and adequate retirement income and to cover all or most workers. In each of these respects, the system needs better solutions. With the decline in defined benefit (DB) plans and the increasing reliance on 401(k) plans, future retirees will have less secure and less adequate retirement income than current retirees.

These issues are addressed in the book *Pension Policy: The Search for Better Solutions*, which was recently published by the Upjohn Institute (see p. 7). This article summarizes the main policy recommendations from the book.

Policy Recommendations for 401(k) Plans

Since the 1980s, the role of 401(k) plans has changed from being mainly supplementary, offered by employers who also offer a DB plan, to often being the only plan employers provide. However, 401(k) plan regulation has lagged in recognizing its increasingly important role.

The regulation of 401(k) plans should be changed so that two types of plans would be recognized. First, 401(k) *retirement* plans would be the primary or sole plan provided by an employer and would be regulated as retirement plans rather than savings plans. The goal here is to close the regulatory gap between DB plans and 401(k) plans. For example, the 401(k) *retirement* plan would be required to offer an annuity as the default payout option, with spousal consent for not taking a joint and survivor's annuity, similar to the spousal protections provided by DB plans.

The second type, a 401(k) *savings* plan, would be offered by employers that also offer DB plans meeting minimum standards as to generosity. These plans would continue to be regulated as they currently are, reflecting their historical roots as secondary plans that supplement DB plans. Having this two-tier regulation of 401(k) plans could encourage employers to offer DB plans because it would permit them to offer 401(k) plans meeting less rigorous standards.

Participants in 401(k) plans often unknowingly bear the plan's investment costs and typically also the administrative costs. The fees they pay (in dollars), as well as the expense ratio for investment expenses, should be disclosed on annual and quarterly account statements. This type of disclosure is done in Australia for administrative fees and by the Janus mutual funds for investment costs.

While the focus of much pension research is on inertia by pension participants, a seldom discussed problem with the coverage provided by defined contribution plans is the lack of persistency of contributions by many workers. The lack of persistency explains in part the surprisingly low account balances that many 401(k) participants have. Policy has not been developed to address this problem.

With the decline in defined benefit plans, future retirees will have less secure retirement income than current retirees.

Policy Recommendations for Defined Benefit Plans

Some analysts consider the decline in DB plans as an inevitable outcome because those plans are unable to adapt to a changing economic and demographic environment. A number of policies could be considered, however, based on the view that their endangered status is due in part to their regulatory environment.

Private sector DB plans are the only major type of pension plan in the United States that does not permit employee tax deductible contributions. Those contributions are permitted for 401(k) and DB plans for state and local government employees. Extending tax deductibility to private sector DB plan participants would help level the playing field between DB and 401(k) plans.

The increase in life expectancy appears to have contributed to the decline in DB plans, because DB plans are not flexibile enough to deal readily with this continued rise in cost. In the United States, some plans have reduced their generosity, but generally this change is only done for new hires and thus has limited effect on the plan sponsor's costs.

The role of 401(k) plans has changed from being mainly supplementary to often being the only plan employers provide.

Life expectancy risk can be divided into the idiosyncratic risk that a particular individual will live longer than expected and the cohort risk that an entire cohort on average will live longer than expected. Annuity providers are able to manage idiosyncratic risk by pooling it across large numbers of people, effectively diversifying it away. However, cohort risk cannot be pooled because it is correlated across participants. Life expectancy indexing of benefits is one way of dealing with this risk. With that approach, cohort risk is borne by workers, who are the beneficiaries of the improved life expectancy and thus are best able to bear the risk.

A policy innovation, following the Notional Defined Contribution plan in Sweden, would be to permit life expectancy indexing of benefits at retirement. For each new retirement cohort, the generosity of the plan would be adjusted downward to reflect the trend toward greater life expectancy. Under current U.S. law, this innovation would be prohibited because it would violate the anticutback rule, which is defined in terms of annual benefits. If that rule were redefined to take an economist's perspective and use lifetime benefits as the measure, life expectancy indexing would not constitute a cutback in lifetime benefits.

The tax system could be used to encourage broader coverage through DB plans. For example, to tie the interests of management to those of workers, the allowable maximum income considered for determining DB plan benefits could be raised in plans that provide coverage to all full-time workers. Another option could require employers that provide a DB plan for management to also provide a similar plan for employees.

Workers in DB plans who are laid off suffer losses on the benefits they have already accrued. Their benefits are frozen in nominal terms at layoff, and the real value of those benefits is eroded by inflation between that point and the point at which they qualify for retirement benefits. DB plans can make these workers wait until age 65 to receive benefits. For laid-off workers, the loss of pension benefits can be more serious than the loss of wages, while for employers the loss of pension benefits gives them a bonus for laying off workers.

The fees that participants pay (in dollars), as well as the expense ratio for investment expenses, should be disclosed on annual and quarterly account statements.

One policy option is to require firms that lay off workers in corporate restructuring to price index the benefits of those workers until retirement. This obligation in a certain sense would not impose a new cost on employers, it just would mandate that they pay the benefits to these workers that they had promised to pay assuming continued employment.

Funding rules prohibit employers from contributing to DB plans in years that funding exceeds a certain level. This requirement of zero contributions generally occurs when the stock market and companies are performing well. Because pension plans are long-term commitments, and because of the fluctuations in the stock market, at a later date plan sponsors then generally are required to contribute. This requirement generally occurs when the stock market and companies are performing poorly. The temporal pattern of contributions not only increases the volatility of contributions, it forces plan sponsors to contribute on a schedule that is exactly opposite to what they would choose.

To reduce the volatility and timing problem of employer contributions for DB plan funding, the maximum contribution requirements can be eased. For example, plans could be allowed to contribute 25 percent of the normal cost any year, regardless of the level of funding, thus allowing plan sponsors to contribute every year. This is the desired pattern for pension plans, which are ongoing entities that are accruing liabilities every year.

Losing track of pensions is a problem for workers who are laid off or who change jobs. It can be difficult for a worker to find a pension from a former employer, particularly if that employer has gone out of business. Both the United Kingdom and Australia have gone further than the United States in assisting people facing this problem. A national registry, perhaps as an expansion of the registry maintained by the Pension Benefit Guaranty Corporation, would be an improvement in this area.

Conclusions

Pension policy is an evolving product of social institutions and the economy. With the decline in DB plans and the increasing role of 401(k) plans, improvement is needed in the way pensions are provided to U.S. workers. The regulation of 401(k) plans needs to be updated to recognize that they generally are no longer supplementary plans. Policies need to be enacted to strengthen DB plans by making them more flexible and improving the ways they are funded.

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