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“Strengthening Private Employer Pension Plans”

On February 4th, 2009, before another Committee in this House, John C. Bogle, founder and former chief executive of The Vanguard Group, testified:

*“Our nation’s system of retirement security is imperiled, headed for a serious train wreck. That wreck is not merely waiting to happen; we are running on a dangerous track that is leading directly to a serious crash that will disable major parts of our retirement system. Federal support—which, in today’s world, is already being tapped at unprecedented levels—seems to be the only short-term remedy. But long-term reforms in our retirement funding system, if only we have the **wisdom** and **courage** to implement them, can move us to a better path toward retirement security for the nation’s workers.”*

In this context, wisdom means that we have made the investment necessary to unconditionally know-our-stuff! And courage means that our unalienable sense of ethics and morality empowers us to do the right thing.

In the 2,023 days since Bogle’s testimony, has anything really changed? Has “retirement preparation” as undertaken by the average citizen improved, been unaffected, or worsened? And how can it be strengthened?

Background: For 30 years following the end of World War II, a defined benefit (“DB”) pension plan was the centerpiece of the retirement income strategy adopted by most employers. However, with the passage of the Employee Retirement Income Security Act (“ERISA”) in 1974, followed four years later by paragraph “k” being added to §401 of the Internal Revenue Code, the past 40 years have seen a strategic transformation. Defined contribution (“DC”) plans, especially the 401k, have rapidly increased to become the dominant employer retirement income strategy.

Now, various factors have combined to make the reexamination of DB retirement plans both timely and vital. These factors include (in no order) the Great Recession, recurring (and perplexing) economic bubbles, stubborn wage stagnation (exacerbating income and political disparity), a steep decline in union membership and collective bargaining, apparent rips in the fabric of our social contract, et cetera. Investigating this quintette is beyond the scope of this testimony, which has but one objective - to simplify the problem and thus illuminate a rational pathway to effective solutions.

Retirement Preparation Index: Recent generations have seen a shocking decline in the ratio of working years compared to retired years; from 45 years worked to 8 years retired some 85 years ago, to 35 worked and 20 retired today, with 30 years worked and 40 retired in view. Our parents saving enough in 45 years to then live financially secure another 8 years was one thing; our children saving enough in 30 years to finance living 40 years (or more) after retirement is quite another! Adding to the challenge, 19% of those approaching retirement (and 31% overall) report no retirement savings at all. Recent surveys indicate that half of all taxpayers are *on-their-own* regarding retirement; i.e., half don't participate in an employer sponsored retirement plan since none is offered by their employer. Finally, various factors (see above) ensnare the half who are offered a retirement plan (typically a 401k), as too many defer joining, contribute too little too late, mismanage the investment of their 401k nest-egg, retire too soon, spend too much, and live too long.

Pension Cost Formula: While chasing (and securing) a law degree at night in the fifties, three successive day jobs were with a local, then a regional, then a national actuarial firm. It was there that a simple formula used to determine the true cost of a pension plan was taught and learned. The formula:

$$\text{Cost} = \text{benefits paid} - \text{investment earnings} + \text{administrative expenses}$$

Assume in 2014 an employer promises a 25 year old new employee, earning \$32,000 annually, a lifetime pension equal to 50% of his final 5 year average pay to begin in 2054 when he retires at age 65. An actuary could tell us the sum that should be contributed in 2014 to soundly fund this future retirement income liability. But *funding* and *cost* are not the same thing.

To illustrate, parents might save (i.e., fund) \$300 this year in order to send a child to college, but what if the child doesn't go? Or earns a scholarship? You see, the cost will be the tuition actually paid, not the sums saved years earlier. Far too many believe that funding **is** the cost. And as actuarial methods and assumptions are stacked and accumulate, soon logic asks just how precise can an estimate of events decades away really be, anyway? Some even ask whether an "accurate estimate" isn't an oxymoron?

Apples to Apples: Making honest comparisons is tough. Distinguishing cause and effect is also hard; do wet streets cause rain!? A challenge in preparing this testimony has not only been to separate fact from fiction, but to also avoid common *givens*.

There has long been a 4:1 "golden ratio" in pension planning. That is, a future \$4 annual benefit required a current \$1 annual contribution. Thus, an 8% of pay current contribution would typically fund a future pension benefit equal to 32% of pay (i.e., 4 times the contribution). Add social security, averaging around 38% of pay, and a worker could retire in dignity on these two sources of income, plus personal savings - the old three legged stool that delivered retirement income security. This "golden ratio" was just a general rule, of course, and today soaring life expectancy, combined with low (and sticky) investment yields, suggest reappraisal.

In any case, a statutory confirmation of this 4:1 ratio was found decades ago in the "integration" regulations. In the mid-20th century, to "integrate" benefits in a qualified plan with Social Security, an employer could provide a plan benefit of 37.5% of pay in excess of the Social Security wage base. On the other hand, to "integrate" contributions in a qualified plan with Social Security, an employer could make a plan contribution of 9.375% of pay in excess of the Social Security wage base. A door prize to the first person noticing the 4:1 ratio between the 37.5% benefit and the 9.375% contribution!

KEY QUESTION: We have now arrived at the key question. How can pension plans be strengthened?

Visualization: Imagine stuffing dollars into the south end of an empty pipeline until dollars ooze out of the north end. Now, assume that by defining the dollars we want to ooze out of the north end, we can calculate how many dollars we need to stuff into the south end. Or alternatively, by defining the dollars we intend to stuff into the south end, we can calculate the dollars that will ooze out of the north end. In other words, the internal “plumbing” of the pipeline works the same way, whether one prefers to define the north end output (i.e., benefits) or the south end input (i.e., contributions).

Remember the 4:1 “golden ratio”? Its proposition was that a \$4,000 annual pension benefit will ooze out of the pipeline at retirement if annually we poke a \$1,000 contribution in! Of course, by changing assumptions, results will change. So if we want \$4,000 to ooze out, but only poke \$400 in, we will be very disappointed. Likewise, if we want \$4,000 to ooze out, but poke \$8,000 in, we will be elated. Visualizing this pipeline, and the golden ratio, will help a person to better understand the challenge we face to retire citizens in dignity - not despair.

I admit it; Exhibit A on page 4 contains a lot of numbers! Nevertheless, it clearly reflects the value of a \$1.00 annual pension in a matrix containing two variables - 10 investment yields and 11 life expectancies. There are several important things to note. For example, as life expectancy increases, lower investment yields trigger dramatic cost increases. To illustrate, if the yield/expectancy combination is a future 2% and 30 years, instead of a historic 7% and 10 years, pension costs will triple. Since the value of a \$1.00 annual pension would increase from \$7.52 to \$22.84, so would the cost. As Exhibit A illustrates, this wicked combination (i.e., living longer combined with lower yields) has the clear potential to increase pension costs from 400% to 700%.

Three to four decades ago, when the average cost of pension plans might fall in the range of 6% - 8% of payroll, employers turned to the 401k plan. Why? Because it could cost as little as 2% - 3% of payroll. If a demographics tsunami is teaming up with monetary policies (like ZIRP) to double or triple pension costs, the 401k’s popularity will increase. Can long term reforms resuscitate pension plans?

If so, what will it take? Bogle said (see beginning), wisdom and courage. As aforesaid, that prescription requires two things: **(1) reformers must know what they’re talking about, and (2) do the right thing.** Ancients (Aphrodite, the Greek goddess of love and beauty) and moderns (Einstein) have believed that there is a close association between beauty and truth. Is there a beautiful opportunity to strengthen pensions in America?

Yes.

To illustrate, remedial legislation might consider the following ideas and/or concepts:

1. Bar the HCE group (i.e., “highly compensated employees” as defined by ERISA) from participating in a 401k plan unless the company has also established a modest DB pension plan; perhaps a “career average” pension plan with a benefit equal to 1% of pay each year.
2. Provide an annual business tax credit equal to \$100.00 for each of the first 100 pension plan participants.
3. Make a modest DB pension plan mandatory; say a “career average” pension benefit equal to 1% of pay each year, applicable to any company that has not established an equivalent or better DB pension plan.
4. For any company with under 100 employees, double the company’s tax deduction for its pension plan contribution.
5. Require that payment of pension benefits be made in the form of a life annuity contract.

But as Benjamin Franklin's friend, François-Marie Arouet, using his pen name Voltaire, said, *le mieux est l'ennemi du bien* - **best is the enemy of good**. Simplicity is often undiscovered because it is frequently obscured by complexity. Result?

Remedial legislation will require the long view, plus wisdom and courage