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The Great Pension Swindle

by

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OUR employer-based savings system is a mess. Everywhere you look, you see mismanagement, malfeasance, and meltdown.

Collectively, private-sector pension funds are underfunded to the tune of $450 billion. State and local pension funds are short some $800 billion. That's $1.25 trillion in total!

This situation didn't happen by accident. The federal government, with its own $11 trillion unfunded Social Security liability, has condoned the underfunding of private pensions for decades. It's also encouraged pension funds to invest in risky assets to cover their funding shortfalls. Those gambles generally haven't paid off. And it has sat silent as state and local governments turned pension underfunding into an art form.

Who's going to take the hit? America's workers and retirees. Over 1 million private pension participants have seen their pension funds go belly-up. Their pension benefits are ``guaranteed'' by the Pension Benefit Guarantee Corporation (PBGC), a government-established insurance company. But since the corporation limits the amount of benefits it insures, most of these participants have seen or will see tremendous benefit cuts. And there's no guarantee of the PBGC's ``guarantee.'' The corporation is already short $23 billion and needs another $150 billion to deal with pending defaults.

To be sure, most companies with pension plans are solvent and have enough assets to pay the benefits they legally owe. But these legal obligations, technically called accrued liabilities, are much smaller than what they have promised their workers.

What they've told their workers is, ``We're not paying you what you're producing now. But stick with us, and we'll pay you a lot more than you produce as you approach retirement. We'll do this through our pension benefit formula, which makes your pension accruals rise dramatically with your seniority.'' Economists refer to such informal arrangements as implicit long-term labor contracts. To improve retention, workers are underpaid when young and overpaid when old.

About 44 million American workers now participate in pension plans. But these implicit contracts are now being ripped up left and right by the biggest, most profitable companies in the country. Verizon, HP, Motorola, IBM, Sprint, Alcoa, Sears, and Du Pont are among the growing number of Fortune 500 companies that have ``frozen'' their pension plans. In plain English, they have swindled their workers.

Yes, many of these companies have increased their contributions to their workers' 401(k) plans. But these higher contributions are far less than the roughly 10 to 15 percent of pay needed, according to the Employee Benefit Research Institute, to make their workers whole.

The companies engaging in this great pension swindle claim they need to remain competitive. But the future accruals they are cutting represent payment not for current or future work, but for past work. The cuts are nothing less than theft.

Virtually every company with a pension plan is now considering a freeze. The Pension Protection Act of 2006, just signed by President Bush, is likely to accelerate the trend. It requires companies with well-funded pensions to pay higher premiums to the Pension Benefit Guarantee Corporation to cover the losses of poorly funded ones.

Will state and local governments copy this ``best business practice?'' The answer is surely yes. Six states have already frozen their pension plans for new employees. Kerry Healey is recommending that Massachusetts do the same.

The demise of employer-provided pensions doesn't just mean worse work and retention incentives. It also puts millions of future retirees at much greater risk of outliving their money. Retiree and survivor pensions are, after all, generally paid as annuities -- securities that keep paying out until the recipient dies.

What about 401(k)s, IRAs, and other so-called ``defined-contribution'' plans? Can't these accounts be converted into annuities at retirement, and can't they substitute for traditional pensions? Not quite. Many private-sector workers either aren't covered by such plans, don't participate if they are covered, don't contribute much if they do participate (even accounting for employer contributions), don't invest sensibly, or won't use their assets to buy annuities when they hit retirement.

We need to recognize that our employer-based retirement system is in shambles and develop one that works.

If I were asked to advise the president, I'd tell him to a) let the next president fix Social Security; b) eliminate tax breaks to all employer-sponsored pension and all defined-contribution plans; and c) establish the following Personal Security System (PSS):

Single workers would contribute 8 percent of pay to their PSS accounts. Married or legally partnered workers would contribute 4 percent to their accounts and 4 percent to their spouse's account. The government would contribute for the unemployed and disabled and match the contributions of low-income workers. Employer as well as employee contributions to the PSS would be taxable. Withdrawals in the form of PSS annuities would not be.

All account balances would be invested by the US Treasury in a low-cost, market-weighted global index fund of stocks, bonds, and real estate securities. In retirement, each worker's account balance would be gradually sold off by the Treasury and transformed into an inflation-protected annuity. The government would top off any account balance that didn't equal what the worker contributed, adjusted for inflation.

The PSS should appeal to both parties. For Republicans it offers individual accounts, private property, transparency, market investment, and low costs. For Democrats it offers progressivity, downside protection, compulsory diversification, inflation-protected annuitization, and equal investment returns in any given year to all participants.

The reform's extra tax revenues can help shore up Social Security. Thus we can kill two birds with one stone: establish a sound, market-based individual account system covering all workers, and also help ensure that Social Security meets its commitments.

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